H.R. 1062, THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995, GLASS-STEAGALL REFORM, AND RELATED ISSUES (REVISED H.R. 18)—PART 1

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

FEBRUARY 28, 1995

MARCH 1, 1995

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TUESDAY, FEBRUARY 28, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach [chairman of the committee] presiding.

Present: Chairman Leach, Representatives Roukema, Bereuter, Roth, Baker of Louisiana, Lazio, Bachus, Castle, King, Royce, Lucas, Weller, Hayworth, Metcalf, Ehrlich, Barr, Chrysler, Cremeans, Fox, LoBiondo, Watts, Kelly, LaFalce, Vento, Schumer, Kennedy, Flake, Waters, Orton, Maloney, Gutierrez, Roybal-Allard, Barrett of Wisconsin, Wynn, Fields, Hinchey and Bentsen.

Chairman LEACH. The committee will come to order. Today the committee begins hearings on legislation to enhance competition in the financial service industry by providing a prudential framework for the affiliation of banks, securities firms and other financial service providers.

For the past 60 years, Federal laws restricted affiliations between banks and securities firms. While these restrictions contained in the 1933 Glass-Steagall Act made some sense at the time that the Act was passed, they are not appropriate for today's financial world.

It is simply unrealistic for commercial banks to be precluded from offering financial products of customer choice.

It is also unrealistic to maintain by legislation constraints on market competitiveness for securities firms as well as for banks.

In recognition of the need to modernize U.S. banking laws to reflect the rapidly changing financial services marketplace, the committee on Banking and Financial Services begins its consideration today of the Financial Services Competitiveness Act of 1995, which I introduced on January 4 and which has been revised and reintroduced yesterday.

The legislation is a win/win legislation for the banking and securities industry. It looks to the future financial marketplace by dramatically expanding the ability of banking organizations to engage in securities activities and other financial activities.

At the same time, it establishes a two-way street that permits securities firms to be equal partners of banks, not subsidiaries of banks, by permitting securities firms to acquire banks.

While expanding the scope of activities, it also recognizes the dynamic nature of the financial services marketplace by reducing unnecessary, anti-competitive, micromanaging, regulatory burdens that have been previously associated with these activities, all the while preserving safety and soundness.

There are broad philosophical issues at stake in this upcoming debate. The Financial Services Competitiveness Act eliminates many distinctions between commercial and investment banking, but it does not break down the barriers between banking and commerce.

With regard to the issue of merging commerce and banking, care should be taken to recognize that not only do many in American commerce object, such as the vast majority of community bankers and independent insurance agents, but there is also no broad public support for such a philosophical departure.

Indeed, there aren't 500 people in America who advocate this approach; of the few that do, half represent foreign institutions, and the other half several dozen large American companies.

Ours has always been a nation with grave doubts about the concentration of financial power and a preference for the decentralized delivery of financial services.

Ours is also a nation that historically does not approve of the idea of commercial enterprises controlling banks and vice versa. This is, after all, a country of Jefferson and Jackson, a country of individualism rather than collectivism.

As well-known Wall Street guru Henry Kaufman noted in testimony about the subject several years ago, and I quote Mr. Kaufman, "I believe it ultimately puts in jeopardy the fundamental economic democracy in this country, and undermines the crucial need for independent, depository institutions. I emphasize that a merger of banking and commerce would tend to produce an undesirable concentration of economic advancing power while providing no significant compensating benefits."

It is true that Germany and Japan allow certain ties between banking and commerce, but interestingly, based on an aroused public, the Bundestag is currently considering legislation to make German laws more similar to our own.

As for Japan, there are few Americans who have kind things to say about their conflict-ridden system. Whether or not it fits Japan or any other country, interlocking directorships with cross-ownership of banks and industrial companies are largely alien to the American free enterprise culture.

Finally, I would like to stress that I have grave concerns about one aspect of the new Treasury approach unveiled yesterday. The Administration is suggesting that expanded bank power be permitted in the operating subsidiaries of banks.

I believe that such an approach, which is contrary to existing law, is imprudent. Allowing a bank or its subsidiary to engage in risky non-banking activity would jeopardize the deposit insurance system.

The Treasury proposal would grant federally insured institutions direct investment authority for non-banking activities analogous to the direct investment authority that S&Ls garnered in certain States in the 1980's.

Indeed, the news of the week, the failure of Barings, one of Britain's oldest financial institutions, demonstrates the problematic nature of conducting activities in a bank subsidiary, and shows how quickly an operating subsidiary can bring down a parent.

So there is no misunderstanding, while I am pleased the Treasury has come up foursquare for Glass-Steagall reform, I fully expect to oppose its efforts to increase potential liabilities for the deposit insurance system as I will oppose all efforts to merger commerce and banking.

Patently, the Treasury approach appears to be a back door, regulatory consolidation plan designed to pander or push money center banks under the watch of the OCC and the executive branch.

It is my long-held view that the holding company format provides the greatest insulation for insured depository institutions and the greatest protection for taxpayers. It is also my view that, to the maximum extent possible, regulation should be outside of politics, and this is one of the reasons I favor the Fed as a key regulator.

Members of this committee understand that the financial services reform we are contemplating is of historical significance, with large philosophical questions as well as numerous nuances, and with extraordinary ramifications for the financial industry.

In developing this bill, which will serve as the principle markup vehicle, let me stress that we have carefully attempted to balance as many perspectives in as consistent a way as possible, and I am pleased to announce that both Goldman Sachs and J.P. Morgan have endorsed the legislation.

I would like to thank Chairman Greenspan and today's other witnesses for joining us today, and I look forward to their testimony.

[The prepared statement of Hon. James A. Leach can be found in the appendix.]

Are there other members who would like to make openings statements? Mr. LaFalce.

Mr. LAFALCE. Thank you. Mr. Chairman, first of all, I would like to congratulate you for moving the issue of financial services reform to the forefront of our committee's agenda.

I believe this session provides a unique opportunity to take very important and very long overdue steps to modernize the U.S. financial services system and prepare it for the competitive challenges of the 21st Century. I thank you for your excellent leadership on this issue.

In 1991, I had the pleasure of serving as chair of this committee's task force on the international competitiveness of United States financial institutions.

That task force concluded that our financial services policy had failed to keep pace with new market developments, including changes in corporate and individual consumer needs, new technology and product innovation that made the U. S. financial services sector relatively inefficient, unduly expensive, slow to respond to changing customer demands.

The task force report concluded that it was incumbent upon policymakers to undertake a fundamental and comprehensive reassessment of our major laws and the regulatory structures which underpin the U.S. financial system.

There have been several unsuccessful efforts since that time to do so, but I believe we have now finally achieved substantial consensus that change is necessary. And I believe the goal is within our reach.

There are several different proposals before us: Chairman Leach's own bill, which I understand has been revised in important and, from what I understand, very positive ways since its original introduction; Congressman Baker's bill, which is very similar to some bills introduced in the last and preceding Congress, which I have co-sponsored; Senator D'Amato's bill, which is very similar to Congressman Baker's. Now, we have the Treasury Department's proposal.

To be sure, there are significant differences amongst them, but each helps to identify and highlight important issues that we must consider as we move forward. What is very important is that while differences exist, far more important, in my view, is the implicit assumption in all of these proposals that our financial services system requires substantial modernization.

I hope that all of us can keep our eye on that goal, that we can build upon the great many points on which we all agree, and in the days ahead, effect reasonable compromise in those areas where, at this point, we do not agree.

I thank the Chairman.

Chairman LEACH. I thank the distinguished Member.

Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I certainly want to congratulate you and the committee because we are initiating a series of hearings here that mark the beginning of our primary jurisdiction on this subject.

We have, up until this year, not enjoyed the primary jurisdiction, and while I don't expect this to be a rush to judgment, I do think that it demands a long and deliberative process by this committee and a thorough one. I recognize the complexities of the issues, as you've outlined them, Mr. Chairman.

I would also say that in the contemporary context, it is untenable, I believe, to legislatively maintain the restraints on the market that we currently have, and I think there is a general recognition there.

But moving beyond that and acknowledging that, we also acknowledge that there are market innovations and technological advances that require us to modernize our U.S. banking laws consistent with the rapidly changing marketplace.

However, we want to avoid the collapse of the financial markets that led to the Great Depression or the Savings and Loan debacle, so that requires a judicious evaluation of all the proposals out there.

I certainly support the concept of Glass-Steagall reform. It is the duty of the Congress, not the regulators, to enact comprehensive restructuring of the financial services industry, and to make it pos-

sible for all financial service intermediaries to operate more flexibly and competitively, both in the domestic and international arenas.

However, I repeat that if commercial banking organizations are to be granted expanding authority to compete with the securities business, they must do so with the safeguards to enhance the safety and soundness of the deposit insurance system, with special emphasis given to preserving the competitive integrity of the capital markets.

I do have concerns about combining commerce and banking by completely removing restrictions on who can own a bank and diminishing supervision of commercial companies which own banks appears to have a number of risks, and should be explored in depth.

I noted, Mr. Chairman, your reference and quote of my constituent, Henry Kaufman, who expressed those same concerns about concentration of financial power.

Without adequate supervision and proper safeguards, there seems to be little protection against risk or losses from spreading from one company that owns a bank to the underlying bank itself.

Mr. Chairman, I look forward to this long and, I hope, not contentious examination and would hope that at the end of this process we do have a modernization proposal that does protect the financial interests of not only the international financial community, but also our constituents.

Thank you very much, Mr. Chairman.

Chairman LEACH. I thank the distinguished gentlelady.

Mr. Vento.

Mr. VENTO. Mr. Chairman, I thank you. I commend you for the workman-like manner in which we are moving with regard to this, and having the jurisdiction in the committee is a real achievement for you, as Chairman, and for the new majority. I congratulate you for that.

That challenge to respond to changes in the financial marketplace is significant. The regulation rules which interpret 60-year-old laws have been strung out about as much as possible. In fact, there seems to be a great deal of historic revisionism in this process, Mr. Chairman.

Nevertheless, it seems clear with the Administration's endorsement and the major interest in the House and Senate, that we are about to embark on major changes with regards to the precepts that have guided our financial institutions for 60 years.

We need to be very cautious in the process to not throw the baby out with the bath water.

There are cultural differences that exist within our country between entities like commercial banks, insurance, investment banks and securities and commercial businesses. Very significant cultural differences.

They will have a significant impact, of course, on functioning in the American free marketplace, which is different, I would remind my colleagues.

We are not Germany, we are not the United Kingdom, we are not France or Japan. Our economy has significant differences within it, as I said, both cultural and economic, with these other economies which we know are much more centralized and much more integral

in the involvement of the governance and the operation of the economy.

It is often said that you can't tell where the government ends and the private sector begins in countries like Germany.

The argument that globalization of the financial marketplace has to be superimposed upon our banking structure has some obvious shortcomings. We cannot move to the lowest common denominator.

We have distinctive differences that are unprecedented: goals and expectations from our constituents and from our businesses that are integral to our government structure and the businesses, the way that they operate and the way they affect consumers and other business entities.

Risk management and disintermediation, of course, are accelerating. Risk management, and the traditional instruments that we have, have a great deal of change involved in their dynamic, and so they need to be properly monitored and anticipated in any changes that we make in law.

This is no mean task. I would suggest it is one we ought to approach very cautiously, and I look forward to working with the Chairman and other members as they engage this topic in this Congress.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mr. Roth.

Mr. ROTH. Mr. Chairman, safety and soundness is always our beacon when we are dealing with legislation, especially with financial institutions.

I think everyone is fascinated by the sudden downfall of Britain's famous Barings Bank on Sunday, apparently because of one individual's mistakes or folly.

In the fast-moving and fast-changing world, maybe legislation dealing with every eventuality is impossible, and I think all of us shudder to think it could happen to us.

Whatever we do here in this series of momentous hearings to change Glass-Steagall, we look forward to a good national debate and legislation that certainly will bring us into the 21st Century.

Major changes are in order. That is clear as a bell. My personal goals is to make sure that we increase competition and encourage entrepreneurs, while keeping adequate and appropriate supervision systems in place, as I have repeatedly recommended to this committee over the years, and look to Wisconsin's model and mix of controls in enterprise. There, the financial service industry lives in relative harmony. Securities, insurance, credit unions, thrifts, banking, finance companies. Of course, they have their differences and no system is perfect.

One thing is clear to date, however. Wisconsin's financial services landscape is remarkably free of scandal. We are keeping an effective reign on things that could go wrong. Wisconsin's financial services industry is extremely proud of the clean record, and works hard to keep it that way.

I commend you, Mr. Chairman, for your leadership in holding these hearings, and I know from these hearings will spring legislation that truly will modernize our financial institutions.

Chairman LEACH. I thank the gentleman from Wisconsin. I think some of the accolades he applies to his industry probably apply to himself.

Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman. Let me commend you for your leadership on this important issue. I welcome the opportunity to renew the debate on financial sector reform and modernization after a 4-year hiatus and look forward to a robust and full discussion of the problem.

But, Mr. Chairman, like it or not, we conduct these hearings in the shadow of the Barings failure. It is unconscionable that in the last year we have seen three examples of rogue, out-of-control traders destroying financial firms.

First Mr. Jett at Kidder, then Mr. Citron in Orange County, and finally Mr. Leeson at Barings. A coincidence or something deeper at work?

The bills before us do nothing to answer these questions, and these questions should be answered before we engage in a major restructuring of the financial services industry.

More important and to the point, I am deeply disappointed that neither the Administration nor the Congress is willing to address the most important question in banking reform: how can we ensure that rogue traders like Mr. Leeson do not cause banks to lose billions of dollars of taxpayer-guaranteed money?

If we fail to do this, we will be faced with another S&L-like crisis, and be forced to say to the American people, like Claude Raines in Casablanca: "Gambling here? I am shocked."

If we are going to rewrite the Nation's banking laws as is now being proposed in this committee, in the other body and by the Administration, we must be extremely careful about the linkage between government-insured deposits and the risky activities conducted by financial institutions that accept such deposits from the public.

There are many issues to discuss with respect to these proposals, and I hope we will get to all of them eventually, but I must say at the outset that I am utterly appalled by one aspect of the Administration's proposal, namely that it would permit new activities to be conducted in bank subsidiaries rather than holding company affiliates.

This is a dangerous departure from current practice, and we cannot allow that degree of control by insured institutions over new, potentially risky activities. I intend to fight it vigorously, and am amazed—utterly amazed—that the Administration would go further than the Leach bill and the Baker bill in proposing that.

Now, let me be clear in conclusion, that I share one fundamental concern of everyone on the committee. The system must be restructured. It is outdated. I'd like to allow all financial institutions to do anything they want, but what we must answer first is: what is the role of deposit insurance? This whole debate is the cart before the horse. Until you deal with how we are going to deal with deposit insurance, you cannot answer what new activities should be allowed.

We got into this problem once before in this past decade with the S&L crisis, and we are going to get into it again unless we examine

that fundamental question. I look forward to doing that with you and the committee, Mr. Chairman.

Chairman LEACH. I thank the gentleman from New York.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I join with many others in commending you for your leadership in this matter, and look forward to working with you over the next several weeks in developing what I believe to be the most responsible system for continued expansion of financial market opportunities.

A brief historical overview of the past 62 years of operation since the adoption of Glass-Steagall reveals the dynamically changing world.

The effect of computer technologies alone on the ability to instantaneously transact business on an international scale is now painfully apparent this morning.

Of even greater significance, however, is the remarkable expansion of the number of non-regulated financial service participants. While banks and thrifts have operated under stringent regulations under products offered, and even where those authorized products may be sold, the non-regulated competitor has not been so constrained. The effects are very clear.

In the earlier part of this century, there were some 30,000 financial institutions. Today, there are some 11,000. Despite all the rules and regulations intended to protect jurisdictions' ability to prosper, there has been consolidation in the market. By contrast, look at the period from simply 1989 to 1993. Investment and mutual funds grew by over 200 percent while bank assets grew by some 20 percent.

Despite the best efforts of regulators and the congressional actions, competitors have generally found a method to deliver the desired product to the market.

Consolidation among competitors, despite the barriers that were constructed, has proceeded at an aggressive pace. Efficiencies of operation have allowed the non-regulated competitor to attract investment that traditional banks have been unable to secure.

The result of these governmental barriers to responsible business conduct is a national financial system that is unable to meet business and consumer needs in the most effective manner possible.

I share the caution that has been expressed this morning in not rushing headlong into an unfettered system which is free to succeed or fail as long as taxpayers remain responsible for those failures of business judgment.

In addition to analyzing the best methods to allow financial markets to grow, we should, as Mr. Schumer has indicated, analyze the best method to insulate taxpayer funds from unsuccessful business decisions.

These are extraordinarily important hearings, unprecedented in their importance to the competitive future of the American financial system.

It is my hope, Mr. Chairman, that under your leadership this committee may take decisive action to build a framework of free enterprise of the future, while ensuring at the same time safety and soundness for every depositor.

Thank you, Mr. Chairman.

Chairman LEACH. I thank the distinguished gentleman.

Mr. Orton.

Mr. ORTON. Thank you, Mr. Chairman. I just wanted to say I know what I have to say about this issue. I would like to hear what Chairman Greenspan has to say. So I would ask unanimous consent that all members be allowed to submit statements into the record, and I yield back my time to hear from Chairman Greenspan.

Chairman LEACH. Without objection, all members may submit statements for the record or revise and extend the statements that have been given.

[The prepared statements of Hon. Kenneth E. Bentsen, Hon. Carolyn B. Maloney, Hon. Floyd H. Flake, and Hon. Maxine Waters can be found in the appendix.]

But I do believe there are one or two other members who wish to be heard.

Yes, Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. I add my voice to the chorus of people congratulating you and moving ahead so expeditiously on this important issue.

There may be differences of opinion as to how to reform Glass-Steagall. I know that you, Mr. Chairman, advocate one approach. My colleague and friend, Mr. Baker, from Louisiana offers another, and now the Administration has weighed in with another proposal. While these measures may differ, all three versions acknowledge that we need to modernize the law that has governed our Nation's banking system for well over half a century.

The regulatory structure established under the Glass-Steagall Act may have served the country well in the 1930's following the calamitous stock market crash and devastating Depression, and the failure of 4,000 banks.

At that time, public confidence in our banking system was at its lowest point ever. However, over 60 years later, this largely unchanged regulatory structure has outlived its usefulness and, in fact, hamstrings the banking community in order to be competitive in today's financial markets.

Under the current structure, strictly speaking, a bank can only own a bank and cannot own other financial entities. Consequently, a bank's sources of capital are severely restricted. When comparing the annual growth rates of financial institution assets over the last decade, commercial banks displayed only a scant 4.9 percent growth.

This lagged far behind other financial entities such as mutual funds whose assets grew at 28.7 percent, security brokers and dealers that showed a 19.8 percent growth, credit unions had a 12.4 percent growth, life insurance companies assets grew at 10.8, and even finance companies' assets increased by 9.1 percent.

It is rational to allow banks to expand their capital base and be permitted to underwrite and deal in corporate securities. This will make banks more competitive with other financial entities which will provide America with a more stable banking system.

The consumer will benefit and, importantly, it will help protect the taxpayer who will be called upon to bail out failed institutions.

Furthermore, more competition in the significantly concentrated securities industry would benefit small and large companies that use investment services as well as individual and institutional investors.

Any potential conflicts of interest that may arise from a bank holding company's subsidiary underwriting the dealing activities can be regulated in the same way that similar conflicts are regulated now in both the banking and securities industries. Therefore, the need to keep investment separate from commercial banking is now obsolete.

Modernizing the banking system allows for diversification, which, in turn, make the system stronger. This is the very reason why we passed the Interstate Banking Act last year. That was a good start, and now we need to take the next step.

And, the structural defects in the banking system of the 1920's or the 1930's were corrected by strengthening the Federal Reserve, the creation of the Federal Deposit Insurance Corporation and the regulation of securities markets.

These hearings are what is needed to put the antiquated Glass-Steagall laws governing our Nation's banking system out to pasture, Mr. Chairman, and prepare our financial institutions for the market demands of the 21st Century.

I commend the Chairman for this initiative.

Chairman LEACH. I thank the distinguished gentleman.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman. Mr. Chairman, I welcome the opportunity to work once again on changing the laws under which the banks of this country operate.

As you are very well aware, this committee has acted in the past to dramatically change Glass-Steagall, and it was not in this committee but rather as a result of other interests that went to work between the time it left this committee and it was voted on the House floor that the bill was defeated.

So I commend you for, once again, attempting to change these laws and for allowing our country to have some of its biggest institutions get bigger and be able to compete in certain areas with other international institutions that already have the same powers that we are seeking to provide here in this country.

To that extent, I look forward to hearing from the Chairman as to how he feels we can build the walls to protect—as I know and am sure he wants to protect—the deposit insurance program and the taxpayers from the kind of experiences that Barings has had recently, and other institutions that we have seen over the course of the last dozen years or more.

The one issue that I hope that the Chairman of both the Federal Reserve and of this committee will ultimately take into account is the fact that if we allow these banks more powers, that we make sure that these institutions are going to provide credit to everyone who needs it.

There is still a very significant problem in providing credit to people of color in this country, and to lower income folks. As these institutions get bigger and bigger, the tendency toward sort of plain vanilla loans is going to increase, not decrease.

I would hope, Chairman Greenspan, that in your remarks you would address the issue of our lower-income consumers can expect to be protected under the Community Reinvestment Act, and your position on CRA as we enter the changes this committee is going to encounter. I think it would be very important for you to speak out on that issue as some point, I hope, today.

Finally, I just would hope that if we are going to include in this issue the whole question of providing these institutions more power, then we also would consider extending CRA to credit unions, the very large credit unions, as well as extending CRA to mortgage companies as well.

I think that those are two organizations that have discriminated against people of color and lower-income people, and I think if we are going to be expanding these powers to those larger institutions, let's make certain that people throughout the country get the access to the credit that they need.

Thank you, Mr. Chairman.

Chairman LEACH. I thank the gentleman.

Yes, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman. I will heed Mr. Orton's advice and be more of a listener than a speaker, to use a campaign expression, but I did want to say that this is one of the reasons that I came to Congress was to have these hearings, to deal with the issues of Glass-Steagall, to deal with the issues of our financial community and some of the consolidation which is necessary, opportunity which is necessary.

I hail from the State of Delaware where we decided about 12 or 13 years ago that if we had proper regulation, proper capital requirements and we dealt with the issue of insurance or whatever it may be, that we could provide opportunities to a variety of competing financial interests to be able to participate in roughly the same lines of business, to compete directly with each other and to benefit from that.

That has been tremendously beneficial to our economy. We have done this without any bank failure whatsoever, and I think we have as thriving a banking community as there is—thriving financial community, I should say, because it is not all banks at this point—as there is any place in the United States of America.

I am convinced that we need to make changes. We have, I guess, three competing plans. There's a lot of overlap with respect to those plans. I hope we just don't have these hearings today, but that we finish this—that we finish it on the floor of the House of Representatives and the Senate, and sign into law fundamental changes to help make America more competitive, to provide opportunities to our financial interests in our country.

I yield back the balance of my time.

Chairman LEACH. I thank the gentleman.

Mr. Metcalf.

Mr. METCALF. Thank you very much Mr. Chairman. As one of the few, if not the only member of this committee who lived all the way through the Great Depression, I have a very, very brief comment.

Times do change, and these days are not the days of the Great Depression. However, some of the laws passed—and Glass-Steagall

included—were passed right after the onset of the Great Depression, and they were passed with great bitterness in a tragic time with a firm dedication to preventing the excesses which, if not caused, were blamed on the banking system.

I think it is legitimate for us now, and necessary, to make the changes and achieve a proper balance, but we must be certain that we don't forget the lessons of the past. Let's keep in mind those who forget the lessons of history are doomed to repeat them.

Chairman LEACH. I thank the distinguished gentleman.

If there are no more opening statements, let me turn to the distinguished Chairman of the Federal Reserve of the United States, Mr. Greenspan.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE BOARD

Mr. GREENSPAN. I thank you very much, Mr. Chairman. I am especially pleased to be here today to present the views of the Board of Governors of the Federal Reserve System on expanding permissible affiliations between banks and other financial services providers. The bills introduced into this Congress, such as that introduced by Chairman Leach, would continue the modernization of our financial system begun with last year's interstate banking legislation.

Chairman Leach is to be commended for his leadership in providing Congress with the opportunity to make the financial system more competitive and more responsive to consumer needs, all within a framework that would maintain the safety and soundness of insured depository institutions.

The Federal Reserve Board believes that modern global financial markets call for permitting financial organizations to operate over a wider range of activities. The approach contained in the new Leach bill would be a major step to providing realistic reform and thus has the strong support of the Board of Governors of the Federal Reserve System.

There is broad agreement that statutes governing the activities of banking organizations increasingly form an inconsistent patchwork. Technological change, globalization and regulatory erosion will eventually make it impossible to sustain outdated restrictions, and these forces will continue to be supplemented by piecemeal revisions to Federal regulation and sweeping changes in State laws. That is what we are here today to discuss, the need to remove outdated restrictions, and to rationalize our system for delivering financial services.

Let me be clear that the Board's position in favor of expanding the permissible range of affiliations for banking organizations is not a reflection of a concern for banks, their management, or their stockholders.

Rather, the Board's support of permissible activities reflects the desirability of removing outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that, as a result, limit choices and options of the consumers of financial services. Such statutory prohibitions result in higher costs and lower quality services for the public, and should be removed. Banking organizations are in a particularly good position to provide broader financial

services to investors. They are knowledgeable about the institutional structure of the market and skilled at evaluating risk. Moreover, for centuries, bank's special expertise has been to accumulate borrower-specific information that they can use to make credit judgments that issue-specific lenders and investors cannot make. Overcoming such information asymmetries has been the value added of banking on the credit side.

Our discussions with section 20 officials suggest that the economic benefits of permitting bank securities' affiliations are probably greatest for small- and medium-sized firms. These firms, as a rule, do not attract the interest of major investment banks and regional brokerage houses do not provide the full range of financial services these companies require.

Rather, their primary financial relationship is with the commercial banks where they borrow and obtain their services. It is thus reasonable to anticipate that as securities activities are authorized for bank affiliates, banking organizations, especially regional and smaller banking organizations, would use their information base to facilitate securities offerings by smaller regional firms as well as local municipal revenue bond issues.

Many of these banking organizations cannot engage in such activities now because they do not have a sufficient base of eligible securities business revenue to take advantage of the section 20 option that limits their ineligible revenues to 10 percent of the total.

To be sure, with the benefits come some risks, but I read the evidence as saying that the risks in securities underwriting and dealing are manageable. Whatever direct risk there is to banks and the safety net, however, we believe is best constrained by the holding company framework which the Leach bill continues.

The Board is of the view that the holding company is also the best framework for constraining the risk of transference and nonbank affiliates of the subsidy implicit in the Federal safety net, deposit insurance, the discount windows, and access to Fedwire, with the attendant moral hazard.

We recognize that foreign subsidiaries of U.S. banks have managed such activities for years, virtually without significant incident. Nonetheless, we have concluded that the further the separation from the bank, the better the insulation.

We are concerned that conducting these activities without limit in subsidiaries of U.S. banks does not create sufficient distance from the bank.

Moreover, even though the risks of underwriting and dealing are manageable, any losses in a securities subsidiary of a bank would, under generally accepted accounting principles, be consolidated into the bank's position, an entity protected by the safety net.

An additional safeguard to protect the bank from any risk from wider financial activities, and to limit the transference of the safety net subsidy to such activities is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain banking and affiliate transactions. However, it would be folly to establish prohibitions and firewalls that would eliminate the economic synergy between banks and their affiliates.

The revised Leach bill retains reasonable firewalls and other prudential limitations, but provides the Board with the authority to

adjust them up or down. Such flexibility is highly desirable because it permits the rules to adjust in reflection of both changing market realities and experience.

Some are concerned that the continuation of an umbrella supervisor is incompatible with a financial services holding company with an increasing number of subsidiaries that would be unregulated if they were independent.

The Board too is concerned that, if bank-like regulation were applied to an expanded range of activities, the market would believe that the government is as responsible for their operations as it is for banks.

This subtle transference of the appearance of safety-net support to financial affiliates of banks creates a kind of moral hazard that is corrosive and potentially dangerous. Nonetheless, it is crucial to understand that both the public and management now thinks, and will continue to think, of bank holding companies and financial services holding companies, if authorized, as one integrated unit, especially if they enjoy the economic synergies that is the purpose of the reform proposals.

Moreover, experience in the new computer technology is already adding centralized risk management to the existing centralized policy development for bank holding companies. The purpose of the umbrella supervisor is to have an overview of the risks in the organization so that the risks to the bank can be evaluated and, if needed, addressed by supervisors. The umbrella supervisor, it seems to us, becomes more crucial, not less, as the risk management and policy control moves from the bank to the parent.

Balancing the supervisory needs of the bank regulators with concerns about the extension of bank-like supervision and regulation is not easy. In an effort to eliminate unnecessary regulatory constraints and burdens, the Leach bill would require the banking agencies to rely on examination reports and other information collected by functional regulators.

The revised bill goes further and eliminates the current application procedure for holding company acquisitions by well-capitalized and well-managed banking organizations whose proposed nonbank acquisitions or de novo entry are both authorized and pass some reasonable test of scale.

Your revised bill, Mr. Chairman, also streamlines the process for evaluating the permissibility of new financial activities. These are extremely important modifications, both for existing bank holding companies and for securities firms that wish to affiliate with banks.

The Board is also committed to continuing to develop supervisory and examination policies that appropriately reduce unnecessary burdens on organizations with bank subsidiaries that are well capitalized and well managed.

But we must not lose sight, and the Chairman's bill does not, that the umbrella supervisor must still be permitted to monitor both the financial condition of the organization and the potential transfer of risk to the insured depository affiliates.

Moreover, we reiterate our concerns of last year that however any structuring is addressed, the Federal Reserve's capability to

monitor large banking organizations in order to respond effectively, that systemic risk not be impaired.

Mr. Chairman, you asked for the Board's views on combining commerce and banking. While the Board supports wider permissible affiliations between banks and other financial services companies, it does not believe that at this time banks should be affiliated with commercial and industrial firms. The Board believes that in a free market there is a presumption of free entry into any business, including banking, although safeguards are required when public monies are at risk.

However, the Board believes that it would be prudent to delay enacting the authority to link commerce and banking until we have gained some actual experience with wider financial ownership of any wider activities for banking organizations. We should reflect carefully on such a basic change in our institutional framework because it is a step that would be difficult to reverse.

Your invitation letter also asked about experience with banking and commerce fraud. A review of the industrial countries with internationally important banking centers suggest that all seven—the non-U.S. G–7 plus Switzerland—permit limited ownership of banks by commercial firms and some ownership of commercial firms by banks.

In practice, despite the legal permissibility, banking-commerce ties are limited. In none of the seven countries are any of the largest banks owned by commercial firms. Banking and commerce affiliations are much more commonly in the form of banks holding sizable equity stakes in commercial firms rather than vice versa. Only in Germany is bank control of commercial firms commonplace, and in that country a banking license is required to engage in any one of a number of credit services which are performed in the United States by non-bank financial institutions.

In Japan, banks' equity holdings are substantial relative to bank capital, but just as in the case of U.S. bank holding companies, a bank in Japan may not hold more than 5 percent of another company's shares.

Our experience demonstrates that there are costs from bank ownership of commercial firms. Banking-commerce ties may induce banks to continue to finance a project beyond the point at which it is prudent to do so.

In addition, equity holdings increase the sensitivity of bank capital to equity market volatility, as has been the case in Japan, thus exposing banks to additional risk.

A third cost, illustrated by Germany, is the tendency for capital markets, especially equity markets, to be less fully developed under a system of bank dominated financing.

Finally, recent losses stemming from bank affiliations with commercial firms, most notably at Metallgesellschaft in Germany and Credit Lyonnais in France, have sparked public debate in these countries about the advisability of banking/commerce ties.

In the United States the public debate continues to focus on wider affiliations between banks and other financial firms. On more than one occasion bills to permit at least securities affiliates were approved by the Banking Committees in both houses of this Congress and on several occasions by the full Senate. In the mean-

time, technological change, globalization, and market innovations have continued. In such a context, modernization of our financial system should be of high priority in order better to serve the U.S. public.

Consequently, the Federal Reserve Board believes it is timely, desirable, and prudent to authorize wider affiliations between banks and other financial service providers. The approach contained in the Leach bill would be a major step in the modernization of our financial system, which sadly now operates under increasingly outdated restrictions and prohibitions.

Mr. Chairman, I have excerpted from my longer prepared remarks and request the latter be included for the record.

[The prepared statement of Hon. Alan Greenspan can be found in the appendix.]

Chairman LEACH. I thank the distinguished Chairman.

We will begin the questioning and I have two brief ones.

The first one relates to merging of commerce and banking. Are there any potential risks posed for the payment system by an institution getting in difficulty if that institution has both commerce and banking components?

Mr. GREENSPAN. Mr. Chairman, obviously the broader the web over which the total financial system and the payment system specifically with which it is involved, the greater the risks that necessarily are involved with it.

I would not, however, emphasize that as a crucial point because the payment system is becoming increasingly elaborate and expansive and ultimately it must address the types of questions which inevitably will occur as we get broader and broader financial coverage of all aspects of the American economy.

Chairman LEACH. I appreciate that. The second question relates to the application process.

As you know, based upon recommendations from yourself and the Fed we have changed our bill to streamline the applications process, partly based upon some concern in the industry that the Fed is in the position of having to review each and every single application, that you've become kind of a clearinghouse of detail.

Would you like to comment on what the Fed is doing in this area and what your views on the application process are?

Mr. GREENSPAN. Yes. Mr. Chairman, the problem that I have very specifically seen on the Board is that we get a very significant number of applications, which should be automatically authorized because they pose no particular problem with respect to sets of standards already promulgated by the Board in other applications. So I should think that we should be able to very significantly reduce the detail of evaluation of lots of applications. Even though we make very strenuous efforts to keep the time involved in approving applications down, the fact is that we have to go through very considerable detail on applications where there is no principle problem because the principle had been promulgated by other application evaluations of similar types. In our judgment a very significant reduction can be made in the application process, and I do think that the banks, which have been concerned about Federal Reserve Board's processing, are correct, even though of the nearly 3,600 applications last year, 94 percent were processed in less than 60 days.

I think we can do a lot better than that and we can do better than that if we are not forced by law to get ourselves involved in unnecessary minutiae of application evaluation.

Chairman LEACH. I appreciate that and I appreciate the new efforts of the Fed to make sure that applications are dealt with on a timely basis.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman. Thank you, Chairman Greenspan, for your testimony and for having it early so we could review it. I think that's very helpful.

I note there are so many differences here that exist and so many questions that have to be answered, in my opening remarks I spoke about cultural differences within and without—in terms of comparing the international scene of Germany and the United States or Japan or France.

The other of course is within, and the real question I suppose is investment bankers don't behave like commercial bankers or insurance companies don't behave like commercial business enterprises. You know, it has recently come to my attention that some of the major mergers that we have seen take place have largely failed to come to grips with that in a timely fashion, which can cause some rather serious problems.

Is that or do you anticipate that as a problem?

Mr. GREENSPAN. Well, every institution, no matter what it is, has its own culture, and it evolves a culture even sometimes independently of the way the organization is structured because that's the way individual firms become effective.

When you try to meld one culture with another, which is true of virtually every merger, and that is true even between commercial banks, and if you start to look at relationships between commercial banks and investment banks, you do have culture clashes. That is inevitable, but it is one of the characteristics of mergers which are overcome and have to be overcome.

Mr. VENTO. Well, let's talk about some of the other things that aren't—I mean I don't think it's a casual concern.

Mr. GREENSPAN. No, I can agree with you.

Mr. VENTO. In terms of making our economy work, I know it's kind of an intangible and we can't write it into law, but I think it is very, very significant in terms of how our economy works because, believe it or not, there are a lot of things that happen that aren't written into law here in Washington with regards to this free market economy or at least the form of it that we have.

But there are some differences. If we look at other nations and we see this sort of vertical integration and government ownership in terms of the private sector, they don't have a lot of the problems. Our banks, our investment bankers, our insurance companies are motivated by profit and they are privately owned—I mean private versus government ownership does represent significant conflicts that can arise.

In spite of the historic revisionism that was spoken of in terms of why we have Glass-Steagall, I think the elements are still out there. They are largely privately owned—I guess the suggestions you are talking about, proper insulation, we are not all on the same

circuit here in terms of the circuitry that exists with regard to vertical or more horizontally work in terms of our institutions.

Mr. GREENSPAN. Congressman, we are quite sensitive to the issues you raise and have become aware of various different cultural differences and institutional differences which are inevitable as different economies evolve in different ways and different institutions evolve in different ways.

One of the jobs that we as a supervisor have got is to basically find a way in which we recognize that and adjust our practices and try to induce changes in the practices of the banking system in a manner to overcome those types of problems which are really a function of human nature. You are not going to change them. You just have to deal with them. The problem is to deal with them as best we can.

Mr. VENTO. Let's talk about some of the numbers.

You know, the banks are far better capitalized, have much more capital than investment bankers or insurance companies. Some have proposed, of course, that they work together, which would in essence mean that the banks, as they did in Canada, may well absorb the investment banking industry.

You point out that—and you might want to expand on this, and I think that that is my projection.

My prediction is that these investment banks could become wholly owned by the financial institutions. You'd no longer have the sort of independent entity as an investment banker in terms of its function, and then there's a bias toward loans.

You in fact point out that in the German market for example, they have a very weak equity market in terms of sales of stocks and bonds and underwriting paper.

Can you expand on that and what the policy path might look like in terms of extrapolating what the structure might be in terms of ownership patterns between investment bankers and commercial banks in the future, even the various——

Mr. GREENSPAN. You mean in the United States?

Mr. VENTO. Yes, right here, and then what it means to the marketplace. I mean that's actually what we need to have.

Mr. GREENSPAN. Yes. It's difficult to know exactly how the system will be restructured.

The more important issue, Congressman, is basically to recognize that the nature of the financial products which we are producing in this country are becoming increasingly homogeneous in the sense that the types of products which we used to believe were commercial bank-type products and the types of products which were investment-type products are becoming increasingly less obvious to differentiate.

So what we are beginning to see is that as the sophistication of the system increases, everybody is getting into everybody else's business, which is not bad. It's creating increasing competition, increasing efficiency, and very significantly helping the consumer with respect to his financial services requirements.

So we're going to see, inevitably, various different types of mergers going on and that's good, not bad, because it improves the competitiveness of the system and I think that as the years go on, if some significant change of the type that is being discussed today

occurs, the efficacy of the American financial system will improve very significantly.

Mr. VENTO. Well, Mr. Chairman, so long as it doesn't freeze the configuration of what those instruments are but freezes it in place because if you eliminate the factor of change, that would be a different factor.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I noted in your testimony your very coherent and cogent assertions regarding the competitive—global competitiveness and needs for the financial market. In my own language I call it the financial grid. You explained that quite nicely.

But now with the revelations concerning Barings, whether it's derivatives or other matters, but mainly the focus is on the derivatives aspect of it, can you put that in the context of how we deal with these international financial matters in a new environment with the proposed legislative changes that you have recommended?

How do we avoid financial collapse in this international financial grid, specifically derivatives or any other instruments that we might not have yet focused on?

Mr. GREENSPAN. Congresswoman, one of the times I was up here in recent weeks I was confronted with precisely the same question in a different context.

Mrs. ROUKEMA. Yes, I think you were.

Mr. GREENSPAN. The answer is going to be pretty much the same.

What we are dealing with is because of computer and telecommunications technology we are observing a very rapidly expanding, increasingly sophisticated financial system internationally whose bottom line basically is that it will improve the standards of living, indeed has already improved the standards of living of all concerned, but it has the same characteristic of moving financial products around the world very rapidly to be of help.

It also has the capability of moving mistakes around the world, which could be a problem.

The basic concern that I have is that we, the supervisors, both in the United States and our counterparts abroad, become increasingly aware of the rapidity in which the system moves and the capability of individuals doing huge things relative to what they were able to do previously.

In other words, the most recent example of this last week in Barings is a very interesting case, not because it's a particularly new product—I mean futures markets in organized exchanges have been around for a very long period of time and stock index futures, which is the base of what has been going on here, have been around for more than a decade.

The basic issue is that the technology has gotten so sophisticated that you can do huge amounts of things by pressing a few buttons, transmitting a few instructions, and creating vast types of trades, which one could not have done a generation ago.

What this tells us, indeed it's nothing new—we have been aware of this phenomenon—is that we have to become acutely aware that

the size of the markets are much larger and because of technology individual traders have the capability of engaging far more vastly than ever before and it is that which we must be acutely aware of.

Mrs. ROUKEMA. Well, given that, how in this legislation—it seems to me that puts a tremendous burden on the Fed. How does the Fed anticipate that before the collapse happens?

Mr. GREENSPAN. First of all, we should not presume that we are going to eliminate individual types of mistakes. I mean three were enunciated earlier, namely where individual actions created very major impacts upon individual institutions.

That is going to continue and it is going to continue basically because the technology is there for that to happen and it is going to happen on occasion.

What we have to be careful about is to make certain that it does not become systemic, and it is not a solution to believe that we can find some legislative vehicle which basically says "Thou shalt not do that."

Unless you want to reverse technology, unless you want to reverse knowledge and move the clock back, it's not capable of being eliminated. Human nature is going to do what human nature has always done, bad things on occasion. Our job is to prevent that from becoming systemic.

It is the job of the individual institutions through internal controls to make certain that they don't lose their capital as a consequence, as indeed happened over this last weekend.

Mrs. ROUKEMA. Well, that's a lot to think about, whether we can supplement or coordinate what you are doing through statutory requirements or whether we totally under this tremendous—greater economic concentration whether we can leave it to the Fed or some other entities to set up the structures which may or may not be adequate now.

Mr. GREENSPAN. If I could think of improvements that could be made either with other supervisors, regulators or other legislation, I would be forthcoming as quickly as I knew how before this committee to hope that such legislation would be enacted.

Mrs. ROUKEMA. We'll count on you for that.

Chairman LEACH. Thank you Mrs. Roukema.

Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

I would like to continue on the gentlelady from New Jersey's very fine questions.

In all due respect, Mr. Chairman, I think you have passed over the major point here. Sure, if Barings fails, it goes down. The people who invested in Barings lose money. Although I have to scratch my head and say, you know, this is not just an individual because how did one individual, how was he allowed to risk more capital than the firm had? That goes to systemic risk.

Yesterday I called up four or five people in the financial industry that I know and I said do you think the firms in the United States have different kinds of checks than Barings did so that one individual could not risk more than the entire capital of the firm?

I hate to tell you the answers I got were disconcerting. It's not that they said yes and it's not that they said no. Basically, reading

the answers I got, they said, well, we're not sure, we hope so, but we're not sure.

That, to me, gets to the point—I mean I think when you have these instances it is not just one individual because individuals will always make mistakes. That's how capitalism is and should be—live by the capitalist sword, die by the capitalist sword—fine with me, it's a great system.

But when the firms, when the technology is such that the 28-year-old trader knows more about what he is risking than the 55-year-old chairman of the company or the 48-year-old COO, which happened at Barings, always regarded as one of the most conservative, best managed firms not only in the United Kingdom but the world, something systemic is the problem. It is the technology. We can't turn the clock back, of course, that's a straw horse, but it's that technology has gotten so far ahead of things that there aren't good controls, and so my question to you is, given that and given the fact that we should let firms fail, isn't the big question what do the taxpayers have at risk?

What about insured deposits and given the fact that we know so little about why a Barings could happen and why a Kidder-Peabody could happen and why, bet my bottom dollar, there will be five more of these in the next 2 or 3 years, why they will happen, why are we going to possibly put insured deposits at risk when we do these kinds of things?

That is my problem because if this were a bank, if Barings were a United States bank, right now the taxpayers would have been at risk.

I don't care about the investors. That's their business, but it would have been the taxpayers, and I have no guarantee, maybe you do, that one of our major banks has a kind of system where no one or all these traders together aren't risking on one bet or two bets an amount greater than the capital of the bank.

Mr. GREENSPAN. Congressman, let me first say this. There's a definitional question of what the term "systemic" is being used for.

I am using it in a somewhat different context than you are. What I mean by systemic is that when an institution fails the contagion of that failure creates financial problems for the international or domestic financial system as a whole.

It is true that there are other types of systemic failures. That's a different use of the term.

Mr. SCHUMER. Fine, I accept your definition, but I would say we have failures, systemic failures meaning widespread. There's possible widespread Barings that could occur because of the lack of checks within each firm.

Mr. GREENSPAN. Let me say this——

Mr. SCHUMER. Is there?

Mr. GREENSPAN. To the extent that there are breakdowns in the controls within a specific firm it obviously has a major effect on the firm. It might have a broader, systemic effect, for example the way Drexel-Burnham did.

Mr. SCHUMER. Right. Also an uninsured institution.

Mr. GREENSPAN. Sure.

Mr. SCHUMER. I'd like you to address what happens when we deal with insured institutions.

Mr. GREENSPAN. I think that—basically I am very much concerned about the issue of making certain that we keep the safety net very restricted in use and essentially because it is only through the safety net that one creates risk for taxpayers.

If you have uninsured institutions out there and institutions which do not have access, for example, to the discount window or Fedwire where they can create certain problems for the rest of the system, then they are free to do whatever they want and to go belly up if they so choose, but the whole notion with respect to the hearings that we have here, the whole notion with respect to how we ought to organize the structure of institutions that we have is to distinguish between those elements which affect the safety net and therefore the taxpayer and those that do not.

We must be aware that those that do not should be free to do whatever it is they choose, but those that are involved directly or indirectly with deposit insurance, with discount window loans at the Fed or the Fedwire are required to be supervised in a manner to constrain the risk to the taxpayer.

Mr. SCHUMER. My time is up but I would simply premise, and this should be a greater discussion, that neither of the bills before us has any kind of not even iron-clad but limited—neither of these bills really answers the question: Are insured deposits at risk? We'd better, in this brave new world, answer this question before we rush to endorse any of those proposals.

I thank the Chairman.

Chairman LEACH. I appreciate the gentleman's comments and before turning to Mr. Bereuter let me also say on the committee's docket this year is going to be derivatives legislation of another ilk that touches on about 10 percent of the gentleman's concerns.

Mr. SCHUMER. I would just say to the gentleman I appreciate that but I am not focusing on derivatives here as much as there are going to be 20 new risky types of activities, their relationship to deposit insurance, not derivatives per se.

Chairman LEACH. Fair enough. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman. Chairman Greenspan, thank you very much for your testimony.

Picking up on the comments started by the question by Mrs. Roukema, we have already a highly integrated global business system and we have a highly developed instantaneous communication technology system to support it.

It seems to me that has all kinds of troubling implications for central bankers but we also have the difficulty that we have nation states and we have a whole array of central bankers, and if we can't block technology, and we have agreed to that among ourselves here in the last few minutes, doesn't it mean that we have to have the technological capabilities among the nation states' central bankers and other kinds of financial regulators of those major countries to deal with the problems that can reverberate around the whole globe?

We don't have that. I don't see the potential for having it in the near future, and doesn't that suggest therefore, among other things, that perhaps the best we can do is to have compartmentalization so that we limit the damage until we have an inte-

grated system on the regulators' side, the central bankers' side, to match the emerging global economy?

Mr. GREENSPAN. Congressman, I testified previously on the very tricky question that you are raising.

What's becoming clearer is that as a consequence of the increased computer and technological sophistication the old conventional procedures that central banks and other examiners of banks used to be involved with is no longer going to be adequate in the 21st century.

It used to be that at the close of business you had one specific balance sheet. You could examine it. It wasn't all that difficult. What we now have is very complex and sophisticated processes of the large international banking institutions, which create extraordinarily complex possibilities of market risk and what we are doing, we and our counterparts abroad, is looking more at the process of the way those models are developed within the institution so that the risk management is not an issue of our coming in after the fact and looking at what they did, but we try to focus very specifically to ensure that the procedures that these large institutions are involved with are adequate and sensible for constraining risk within the firm.

That in my judgment is the direction in which bank supervision inevitably is going to be moving.

Mr. BEREUTER. Thank you. Now if we repeal or reform Glass-Steagall, almost necessarily this would give the Fed power over the securities industry. That follows, it seems to me, but as a central banker are there reasons why you today, your institution, in this global economy to pursue its responsibilities as a central banker, not as a regulator, should have power over the securities industry?

Mr. GREENSPAN. No. I don't think that we consider that necessary. What we consider necessary basically is for us to have a general umbrella supervision over large international banks and a sufficient spread across smaller institutions, even some community banks as we do now to give us a sense of the way our system works.

The ability that we have to interface, for example, with the Securities and Exchange Commission and to talk to these other investment banking institutions which are relatively few in number so far as our systemic concerns are concerned, has been adequate in our judgment and we don't perceive the necessity of our gaining any regulatory foothold in any of these large institutions.

Basically we need additional information, but we seem to be able to get that and certainly the Securities and Exchange Commission is endeavoring to pick up the types of information that we think are necessary and we find our ability to share with them is more than adequate for this purpose.

Mr. BEREUTER. Chairman, I wonder if you could tell us if there are any benefits to U.S. banks doing business overseas by the repeal of Glass-Steagall?

Mr. GREENSPAN. You mean our banks——

Mr. BEREUTER. Our banks. It's obvious what the advantages will be for foreign banks in the United States.

Mr. GREENSPAN. Yes. Off the top of my head the initial response is no, in the sense that so far as functions are concerned they can

operate in the context of the particular laws which are involved in the countries in which those branches are located.

To the extent, however, that the removal of Glass-Steagall enhances the financial capability of the domestic firms, which means that it can be of greater assistance to the foreign affiliates, to that extent I think it will be helpful.

Chairman LEACH. Thank you. Mr. Kennedy.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman Greenspan, just a point that sort of extends the issues that were brought up in the last few questions. Wasn't it like 1989 that you allowed in some way or another one of the big Chicago trading houses access to the Fed when the market dropped about 100 points or something in one day? Didn't you allow them—didn't you pump some money into one of those?

Mr. FLAKE. You mean investment——

Mr. KENNEDY. Yes, it's like some kind of—I think it was a firm that was trading in some sort of futures markets or something like that?

Chairman LEACH. If the gentleman will yield, I think you are talking about First Options and Continental Illinois, but I may be mistaken.

Mr. GREENSPAN. Yes, I think that you are referring to the First Options issue, which we were not involved with—First Options was a sub of the bank.

Mr. KENNEDY. OK, but did you allow some Federal funds access to a non-deposit FDIC insured institution?

Mr. GREENSPAN. Not to my knowledge, no.

Mr. KENNEDY. Mr. Chairman, is that your understanding?

Chairman LEACH. That's my understanding as well. There are arguments regarding whether Continental may or may not have exceeded its authority and it's one of the issues regarding whether or not you have a sub versus a holding company structure but the Federal Reserve Board itself did not, to my understanding, pump any funds in.

Mr. KENNEDY. Were you aware at the time, Chairman Greenspan—thank you, Chairman Leach, for that clarification—were you aware at the time, Mr. Greenspan, that Continental might have been providing funds to a sub in excess of its limit?

Mr. GREENSPAN. My recollection is that we were quite aware of the First Options issue, what was going on in First Options, if that's what you mean—well, at least that's my recollection. I remember many telephone calls on the subject.

Mr. KENNEDY. I would imagine that one would have stuck with you but anyway——

Chairman LEACH. If the gentleman would yield——

Mr. KENNEDY. Yes.

Chairman LEACH. I think structurally and regulation-wise, Continental was under OCC regulation and perhaps FDIC partial control at the time, but the Fed was a step back from those.

Mr. KENNEDY. But I think the Chairman would recognize that the point I am trying to make is that there was a firm, there was a bank that had—I guess it owned a subsidiary. The subsidiary overstepped its limits and the bank used its ability to get Federal funds to then extend credit in some way.

Listen—I got the big guys shaking their head yes and one guy shaking their head no behind you, but it's something along those lines, all right? [Laughter.]

Mr. GREENSPAN. No, what it was as I recall is that Continental put more capital into First Options than it was legally capable of doing——

Mr. KENNEDY. And you knew that?

Mr. GREENSPAN. No. This was, as I think the Chairman pointed out, this was the OCC's operation and that we were informed about it after the fact by the bank.

Mr. KENNEDY. OK. Well, I guess that would make the point that I am trying to make even more clear, which is that you didn't know it and it still happened.

Mr. GREENSPAN. Sure. Absolutely. If you are telling me that there are violations of the law that we are not aware of before it happens or when it happens, I agree with that.

Mr. KENNEDY. I am not talking about sort of a general violation of the law, Mr. Chairman, I am talking about the fact that deposit insurance money was used to pierce through what is supposed to be a firewall between the bank and an options company.

Mr. GREENSPAN. Yes.

Mr. KENNEDY. And so the implication is that if that could occur way back when, there is a very severe problem that no matter how you design these different firewalls there is going to be some way where you might not even be aware that these institutions are going to be able to rob from Peter to pay Paul.

I just raised that, you know, I really wanted to ask you about CRA and that yellow light is on, so I want to come back and ask you about CRA. I raised it because I have a basic concern that the way we have structured these firewalls does not end up providing the kind of protection to the American taxpayer that we need to if we are going to allow the breakdown of Glass-Steagall.

Let me just ask you, because I am going to run out of time, could you just comment, please, sir, in addition to maybe answering that briefly what your feeling is on CRA with regard to this expansion of powers as well?

Mr. GREENSPAN. Well, as far as I am concerned, and nowhere in this legislation is CRA affected—I assume that is——

Mr. KENNEDY. And you would endorse a policy that would not allow CRA to be weakened at all if this legislation is going to move forward?

Mr. GREENSPAN. So far as I know the CRA is a statute which is unaffected by this legislation.

Mr. KENNEDY. That's not what I just asked you, though.

Mr. GREENSPAN. And therefore must be adhered to according to the law.

Mr. KENNEDY. And you would endorse that?

Mr. GREENSPAN. Certainly.

Mr. KENNEDY. Thank you. Thank you, Mr. Chairman. I would also like to hear the answer to the first question, but what the heck, OK. Next round. Thank you, Mr. Chairman.

Chairman LEACH. The Federal Reserve Chairman has said the law is the law.

Mr. KENNEDY. He went beyond that. Wait a second. He endorsed the CRA. Didn't you hear that? [Laughter.]

Chairman LEACH. Let me turn to one of the truly distinguished leaders of this philosophical debate, Mr. Baker.

Mr. BAKER. Mr. Chairman, I think I understand your philosophic view of markets and how they function and I understand your admonition to move with caution.

I would simply point out that for the better part of 62 years we have been very cautious and not moved at all, that simply taking a step at this moment might not be sufficient. We might at least talk about going for a walk.

In that regard, let me sort of describe what I think is the nature of the universe very generally, and then I will ask just one simple question.

Let's assume for the moment there might be a large software corporation in America today that provides the capability to execute Internet wire transfers between financial institutions. I would call that a financial service.

But assume for a moment that they also have the ability to sell at retail attractive, cute little entertainment software. That might happen. Are they a financial service corporation or are they in commerce? What about a large national insurance company, which I happen to believe to be a financial service, which would also own a national real estate brokerage firm.

If they were to participate in either the bank subsidiary activity or a holding company activity, should that insurance company as a financial interest have to divest itself from its, quote, commercial enterprise of real estate brokerage?

How about if a national credit card issuer, also I believe to be a financial service, happened to be engaged in the travel business and sold suitcases and rented cars? That could happen. Is that really a financial service corporation or are they in commerce?

Now obviously these things couldn't happen in today's world because if you had the blending of finance and commerce, you would have cause for great systemic risk, concentration of economic wealth—all those bad things might possibly occur.

In reality they are occurring and today there is no more distinction between financial services and commerce than there is between a small fire and a forest fire. They are of the same type and source. The question is how do we control the fire.

Do we have the tools adequate to put it out if it gets too big, or do we simply let it sit there quietly and glow inside a light bulb on the wall?

I think that really is the issue that is before the committee. It is not whether in reality commerce and finance have been blended. That happens now. This is not a new thought. We are not entering into a new economic laissez faire era where we are now going to open the doors for the first time and let bright people meet market demand with innovative products. Thank goodness, that still happens in America. What we are focused on, I think, is how to allow the free enterprise market to work with the least amount of unreasonable and costly regulation and yet insulate taxpayers from untoward, unwarranted risk.

If we were able to construct such a system, assume for the moment that we could find a way to insulate taxpayers from those unreasonable business exposures allowing the affiliates or others to participate in whatever business judgments they might make, do you truly have a philosophical aversion to the blending of commerce and finance or is it a practical concern as to the regulatory implications?

Mr. GREENSPAN. Congressman, the reason that we think the merging of commerce and banking at this time is probably not desirable is clearly not a statement of philosophical adverseness.

Indeed, I'll go further than you did in one respect, that as we move into the 21st Century the basic definitions of what we have with respect to financial products and industries is going to change.

The standard industrial classification which we now have and which we use to separate various different statistical classifications like SIC–20 is food and 21 is tobacco—I mean what we are going to find as we get into the 21st Century is that a number of these particular classifications which we have all held sort of rigidly on what is manufacturing, what is non-manufacturing, it's all going to start to go away because the question essentially is at the moment when we produce some very small piece of silicon-based product, we call that manufacturing but it may be that the value added is 99 percent the program, and the question is, is that a service or is that a physical product?

The answer is that it is both. The question of what is a futures and what is a security, which is so heavily involved in the law with respect to jurisdictions between the CFTC and the SEC, that is becoming increasingly meaningless as classifications.

My own judgment is as the economy evolves, it is going to become increasingly difficult to find out where is commerce, where is banking, where is finance.

It's going to be an ever increasingly complex system. I think the principle that we have to be involved with is the one that I stipulated before and you reiterated: How do we protect the taxpayer in the structure of a financial system as distinct from who does what and how it is done.

Mr. BAKER. And that was my point. If we can limit risk, it's not ill-advised.

Mr. GREENSPAN. It is not ill-advised. I only say that it is probably not advisable now because we ought to take one big chunk, and going to financial services holding companies and integrating the system is a very major step. In my judgment, having done that I think we ought to wait and see how the system evolves and move further.

I have no philosophical adverse reaction to the notion of combining various different aspects of business, largely because it is going to become increasingly difficult to figure out what I am talking about. [Laughter.]

I do think that it's probably wise as a practical matter to move in steps rather than to try to move fully without being able to get a sense of where we are.

Chairman LEACH. The gentleman's time has expired.

I would just caution all of us, if the Chairman of the Federal Reserve Board doesn't know what he is talking about, we're all in a pickle but I appreciate his observations.

Mr. Flake.

Mr. FLAKE. Thank you very much, Mr. Chairman and greetings again, Mr. Greenspan.

One of the questions that I still have relates to where we go with the banking industry as a whole, markets. I just saw an article in the *American Banker* today that talks about the fact that Citibank, which is one of the largest banks in the world, will not be serving what it calls the middle market.

Considering what we anticipate for the end of this year in relationship to the resolution of the BIF/SAIF question and realizing that thrifts in so many instances serve that lower segment of the market that many commercial banks and others really don't see as a part of their territory. They don't do business in those communities.

In many instances thrifts are the only institutions that are left. Commercials have already left those communities, so that the largest percentage of those home mortgages, the largest percentage of many of those small businesses that survive because they are there.

You and I have had some discussion before. I am just gravely concerned about the impact if we do not find a way to resolve this inequity before we get to the end of the year.

I have seen some of your statements, yet I have not seen really a clear plan or a clear direction that you may give us as it relates to how we might assure that this phase of the industry survives or even as we talk about Glass-Steagall and what it means to the whole of the banking industry with the realization that if there is a problem in any segment of it the average person does not see it as BIF or SAIF or commercial or thrift. They just see the whole industry in trouble.

I would just like to have your comments in terms of how you think we might be able to resolve this what I consider to be a potential crisis.

Mr. GREENSPAN. Yes. As we have discussed previously, Congressman, this is a very difficult issue to resolve and it is an issue basically of Congress confronting how the various different options that will be presented to you work their way out.

We ourselves have not come up with a simple solution. There is no simple solution. It's just a question of how to close the BIF/SAIF problem.

There are obviously those who believe there is no such problem. My own view is I think there is a problem. How significant it is is an interesting issue that has not been clarified but I suspect that there will be hearings before this committee on this issue because it is going to have to get resolved one way or the other, and I hope at that time we will be able to focus some thought and resources on the question and be able to present to this committee, and I suspect our other regulatory colleagues will be thoughtful on this question because I have seen a lot of different potential alternatives.

None of them struck me as that's it, that's the solution. They all look sort of interesting, less interesting, possible, not possible, too expensive. There is nothing that strikes you in all the alternatives that have been put forward that is obviously the direction in which we should go.

We are going to have to find a way that resolves this issue, because I agree with you, I think this is an issue that has got to be resolved.

Mr. FLAKE. Given that most of us see you as a little bit in the super-human category, I guess one reason the question keeps coming to you is you went as high as interesting but nothing very interesting, nothing that moves you. If you are not moved, I think we find ourselves in a bit of a quandary in terms of trying to find some answer.

I guess what we are waiting for is just some cue from you of some combination. Could it be that as we consider Glass-Steagall we could also consider joining in some way the processes so that as you also deal with this issue so that everybody comes out with what they need as it relates to what we want to do in Glass-Steagall and I am supportive of that.

At the same time, I am still concerned about that segment that may be left behind and perhaps this is the time to work through both sides of the issue at the same time and maybe come to the best resolution for all segments of the market that are going to be impacted.

Mr. GREENSPAN. Congressman, I think that the BIF/SAIF issue is fundamentally a budget funding problem at root. The Glass-Steagall repeal is not, and I would be hesitant to try to add the complexities that are involved in trying to solve a budget funding problem into the Glass-Steagall issue, because I think that it will probably contaminate both.

They should be handled separately but I do agree with you that there is a certain urgency here that it's got to be addressed and sooner rather than later.

Mr. FLAKE. Thank you. I yield back, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Flake. Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. Good morning, Chairman.

I wonder if we could speak about definitions a little bit.

In the Chairman's proposed mark, he has altered the Bank Holding Act—actually he replaced it—modifies the "closely related to banking" test with language that would allow activities "financial in nature."

What does that mean to you? What would be included in that?

Mr. GREENSPAN. Well, we have had enough difficulty with the question of closely related to banking. When you start to get to the issue of what is financial in nature, your colleague on your right is going to say that is a very fuzzy concept to begin with.

What I think would be required, if in fact this particular piece of legislation goes into law, is that it is going to require a good deal of thought on our part and others who are involved in making that type of decision to find an operational means of coming to grips with the issue.

Fundamentally, I agree with Congressman Baker that at root it is very difficult to make an exact definition because once you have

done that you are going to find as the years go on it's going to get fuzzier and fuzzier.

Nonetheless I do think that we have to draw the line at least temporarily as this process goes forward and inevitably it's going to be a line which is probably going to be partially inequitable to some groups or some people.

I hope we find a way of getting clearer definitions and we will be required, obviously, to go out for comment and various different rulemaking procedures. I think this will be true of the Fed. It will be true of the Comptroller. It will be true of the FDIC so far as banking regulatory organizations are concerned, and we'll just have to see how it works out.

I can't give you an easy answer.

Mr. LAZIO. I think for some of us this strikes at the heart of the problem. It's very difficult to legislate in this area unless we have an understanding at least conceptually of what industry groups are implicated.

Are insurance services implicated? Are credit card services? I mean are those type of things, are those financial in nature in your opinion?

Mr. GREENSPAN. In my opinion, yes, in what you said, I believe they are financial in nature. When you get into real estate development, I think that is another issue. I mean it depends on where you start to draw the various different lines and we would all draw them slightly differently, but I do think that 95 percent of where the lines are drawn, if I may put it that way, are in the same place.

Where the differences are are on the margin, not in the broad substance and so long as that is the case that while we do have a problem I don't think it is a monumental one to deal with.

Mr. LAZIO. Let me just ask—I think I have a little time left—one of your concerns is systemic risk and another has to do with the taxpayer exposure through the deposit insurance, if I understand you correctly.

To what extent are they mitigated through potentially bifurcated or higher levels of capital reserves for certain deposit institutions that might be given—I am talking theoretically right now—be given more flexibility to diversify if they had higher capital.

Mr. GREENSPAN. I'm sorry, I didn't quite get it. Would you give me that again?

Mr. LAZIO. To what extent would your concerns be mitigated if banks, if certain banks were required to have higher reserve——

Mr. GREENSPAN. Capital, you mean.

Mr. LAZIO. Capital in order to diversify?

Mr. GREENSPAN. Well, implicit in all of these discussions is that institutions that are going to be involved in this type of thing have to have adequate capital levels which enable them to function in a manner which if there is an insured banking institution in the financial services holding company that that institution is not at risk and that the taxpayer is not at risk.

Mr. LAZIO. Can you imagine a system that would bifurcate the reserve analysis on the part of the Board so that those banks that diversified had some higher level——

Mr. GREENSPAN. You are not referring to the narrow bank question, are you, where you are splitting up an institution? I'm not quite getting the question, I'm afraid.

Mr. LAZIO. Let me follow up with you. I think our time is up and I'll follow up with you in writing.

Mr. GREENSPAN. OK, I'm sorry, I'm not quite clear on what——

Chairman LEACH. Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Greenspan, we have talked about Glass-Steagall reform or replacing Glass-Steagall, how about the Bank Holding Act, Holding Company Act?

I read an article by William Isaac in the *American Banker*—I don't know if you read that—where he advocates it ought to be at the top of the list in repealing.

Mr. GREENSPAN. That would have been my view a number of years ago until I became increasingly aware of the importance of umbrella supervision for purposes of maintaining a systemic control of a system where unless there is umbrella supervision I think the system goes to risk. So I would say at this particular stage that whether or not you are dealing with the bank holding company or financial services holding company, whereas in earlier years I would have thought that we could basically by functional regulation essentially endeavor to supervise individual affiliates as and when necessary, I think as the system has become increasingly more complex and the type of global finance that we have been talking about earlier is becoming a dominant force in the system, unless you eliminate the safety net and the risks to the taxpayer, then I don't see any alternative to having some form of umbrella supervision.

Where you have an organization which doesn't have any insured institution in it or involvement in the safety net, then I think umbrella supervision is irrelevant and inappropriate, but so long as you have within that organization an insured institution and involvement with the safety net I don't see any way that we can protect the taxpayer unless there is an element of umbrella supervision there, and that is largely what the elements of the bank holding company that I would consider that must be involved here rest.

Mr. BACHUS. Are there any proposals to make changes to the Bank Holding Company Act that you know of by the Administration?

Mr. GREENSPAN. Many of the elements that are, for example, in the Chairman's bill do significantly alter some of the aspects of the Bank Holding Company Act and I would suspect that virtually all of the types of bills that we are seeing including Congressman Baker's and others in the Senate will radically alter the Bank Holding Company Act.

Mr. BACHUS. My other question, I was reading what Eugene Ludwig said about firewalls and that if they are too rigid they will cause some disadvantage to the banks in what we are talking about—giving them certain rights.

Are you advocating more rigid firewalls than the Comptroller or is there any disagreement?

Mr. GREENSPAN. No. Look, my own view is that firewalls are not as effective as we used to believe or not I but say the Federal Reserve used to believe they were.

I think that under stress they tend to melt inordinately.

They have some marginal effects along the way but I would not be a strong supporter of rigid firewalls largely because I think they reduce the synergy that is so useful in the process of breaking down Glass-Steagall restraints and I think that in large measure both the corporate veil and firewalls get very shaky in a crisis. When you really want them to function, they don't.

My concerns about issues with respect to, for example, subsidiaries of banks as distinct from parents, have very little to do with the firewall question which a lot of people have argued in favor of and more to do with the question of the subsidy that is involved that commercial banks would move to the subsidiary of the bank as distinct from the issue of believing you can move institutions away from the bank by erecting significant firewalls.

I am not altogether convinced how successful that would be.

Mr. BACHUS. Thank you.

Chairman LEACH. I thank the gentleman.

Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman. Mr. Greenspan, I think you have discussed this somewhat today, but I would just like to share with you that my concern is simply the concentration of economic power. I am concerned about little things like unity banking, CRA and consumers. As I looked and listened to this discussion, it appears that we may end up with financial conglomerates that will not be covered or regulated in ways that will protect consumers.

Does this concern you at all? Do you have any thoughts about what we perhaps could do to ensure—as we move toward this kind of reform—protection for consumers and smaller operations?

Mr. GREENSPAN. Congresswoman, I think the kind of legislation discussed actually enhances financial services going to consumers because, in fact, it enables efficiencies to be expanded beyond where they are at the moment.

I would say, however, that the vast proportion of community banks, the very small banks, are not likely to come up with securities affiliates or a number of other elements involved in the changing financial services structure.

The reason is that they've got a very effective business as it now stands—they have a competitive niche which large companies are not going to be able to breach. They've tried in the past, but there is something about a small banking institution, which I've observed over the years, that has got competitive advantages over these larger institutions.

So I don't see—I do see that medium-sized institutions where middle-sized companies which now do not have access to securities markets will be helped, but I don't think this is an issue for small business or very small banks.

I think that they do what they do and they do it very well. This does not directly relate to them, nor, in my judgment, does it undercut in any way their competitive capabilities.

Ms. WATERS. But, Mr. Chairman, we don't know what these new entities could be. I think there was some previous discussion about possibilities that have not been thought about. We've talked about combinations of commerce and retail, and so forth.

My concern is that these small banks who cannot offer diversified services would be as competitive as you are describing them to be now, and perhaps would not be able to remain at all given this new configuration of financial services that could be almost anything.

Mr. GREENSPAN. Remember, that any institution—if any of this legislation gets passed, and I hope that something does—any institution will have the capability of employing various increased services if they so choose.

But the kind of services which small community banks put out are not the types of services which are a vast variety of new types of products so much as it is personal banking service and one-stop banking.

The basic type of product that is produced there is not materially affected by the types of institutions that would evolve in this type of new regulatory environment. I don't see how, in effect, if a large commercial bank gets a securities affiliate, how that is going to increase its competitive capability against a small community bank where there are personal services, where the loan officers may also be the president of the bank or vice president, someone who has been around for many years and knows the individuals in that community for years. You can't compete against that.

I don't care how big you are or what type of economic clout that you have. Those, fortunately, are not the type of institutions which, in my judgment, are going to undercut in any way the competitive capability of these types of institutions which serve our community.

Ms. WATERS. Thank you.

Chairman LEACH. I thank the gentlelady.

Mr. Castle.

Mr. CASTLE. Mr. Chairman, I guess my question or questions are premised upon what will happen to the banks if we do not go through some of the consolidation and other opportunity changes that we are talking about in the legislation before us.

As I see in the last few years in banking, there has been a tremendous shift away from banks, per se, to other types of lending, be they international banks lending here or other large corporation funding or the mutual funds dealing with the various accounts that they have for individuals, or whatever it may be.

I guess my question is what is the impact or effect on the U.S. banking system of these changed practices? My impression is that if the banks are not given additional opportunities as interest rates turn down again, and so forth, that it is going to be very hard for them to compete with some of the other lending that goes on by other financial institutions. For that reason, we need to look at merging some of these interests and providing opportunities.

First of all, you may not agree with my premise, which I would be interested in. Second, I would be interested in what your projection of the future of banking would be if we did not do this.

Mr. GREENSPAN. Congressman, the so-called net interest income, which is the basic raw material of commercial bank intermediation,

has been going down as a share of earnings. That is, these and other types of incomes within commercial banks have been rising so that to date commercial banking, per se, looked at in total, is not a declining industry.

But it is certainly the case that where the types of shifts are occurring within the commercial bank from standard loan products, where interest incomes basically come from, to off-balance sheet services, various different types of for-fee products and services, those are increasingly of a securities-type nature. They've been able to squeeze into that area. They have been able, because of the Federal Reserve, to put up section 20 affiliates for a number of institutions—36 actually—who are involved in this type of securities activity.

But unless the system is opened up, it is going to become increasingly more difficult for commercial banks, under the legislation under which they currently function, to be adequately competitive, to keep the viability of those institutions going. Eventually, they will start down.

They have been able, to date, to fend off the decline that would have occurred if they were solely involved in loan products, but that is becoming increasingly more difficult to do, and unless there is a basic change in the structure which we have been talking about today, commercial banking will increasingly be in difficulty.

Mr. CASTLE. In other words, they sort of maximize their opportunities and their markets, and it sort of squeezes where else they can go now. I mean, that is sort of my view of what you are saying here.

Mr. GREENSPAN. Yes.

Mr. CASTLE. You're also saying, I assume, from Chairman Leach's legislation at least, that other financial institutions could go the other way. They could get into the banking acquisition practices so that we could have more merged opportunities than we do today, at least as far as financial institutions are concerned, if not commercial corporations.

Mr. GREENSPAN. Yes. I think what we would find is that competition becomes increasingly fierce, and the one thing we have learned is that the more competition in financial services, as indeed elsewhere, the better it is for consumers because the types of products that we now have in finance are really quite extraordinarily more useful and sophisticated than the one-stop shopping that used to be a notion that no one could figure out how to do when the type of sophistication that we've got is really beginning to work.

Mr. CASTLE. Thank you, Mr. Chairman.

Chairman LEACH. I thank the gentleman.

Mr. Orton.

Mr. ORTON. Thank you, Mr. Chairman. I've been sitting here 2 hours waiting patiently to ask some questions, but my friend from Pennsylvania has a scheduling problem. So, I would yield 1 minute to him to ask a question and then I will return.

Mr. KANJORSKI. Thank you very much, Mr. Orton. It is just for the purposes of excusing myself. Because of a base closing problem, I haven't had the opportunity to listen to all of your testimony, Mr. Greenspan. I am going to read that.

The only question that I have in mind and I worry about is that we have to have a safer and sounder system, that we have to be internationally competitive, but I worry very seriously about secondary markets, not secondary markets where we save funds, but areas that aren't as developed as the primary coastal areas of the United States, as to how this is going to impact them. Our experience has been with the deregulation of operations and airlines and other things that have had an adverse impact on investment and opportunity for growth.

As I read through this, I would only caution one thing. As a ranking Member of the Capital Market Subcommittee, I hope—and I urge that we work with the Chairman and my Chairman—that we really work on a bill here that is truly bipartisan in nature and that meets the needs of all the considered elements in this matter. I am going to do my best to do that, and I will forego the questions, Mr. Greenspan.

Thank you, Mr. Orton.

Mr. ORTON. Thank you.

Chairman LEACH. We will be generous with Mr. Orton's time.

Mr. ORTON. Thank you. I appreciate it. Mr. Chairman, it appears to me that the reason we are all sitting here today is because of the issue of insured deposits, and the concern of risk to the taxpayer funds.

You are here because you are the Chairman of the Federal Reserve, which is one of the principal regulators of insured institutions. So I am led to agree with Mr. Vento that the real issue here is one of the role of insured deposits.

It appears to me that the way in which we guarantee or protect those insured deposits is by managing risk through regulation. As we look at what we currently have, it seems to me we have expanding concentric circles. We have banking institutions right now which are eligible for insured deposits which we regulate. We have ownership restrictions, we have capital restrictions, we have transactional restrictions and so forth to implement those regulations.

The Leach bill would expand that circle to include other financial services type of organizations, including securities, insurance, and so forth, but would again limit within that circle.

The Baker bill, as I understand it, expands that one circle further saying that we would allow non-financial service institutions such as commercial entities, and so forth, to own and be involved in those transactions. Again, maintaining the circle around insured deposits at the banking institution level.

I am very troubled by your conclusion that firewalls tend to melt, since the way we would statutorily protect those deposits is through firewalls between those institutions. If firewalls tend to melt, the thing that we are left to rely upon to protect those is the regulation, period.

Now, my question to you as the chief regulator is: there is a question whether we have the knowledge, the intelligence, the technology, the resources, the manpower and so on, just to regulate those banking institutions. And one example is the issue of derivatives. My question then is, do you honestly believe that you as the Fed and other regulators have the technology and so forth, to r

late those expanding concentric circles, and which expanding circle are you comfortable in going to, to regulate?

Mr. GREENSPAN. Congressman, let me say that while I think that firewalls melt, they don't disappear. In other words, the point that is important to recognize is while they do not do as much as you think they do, they do do something. So long as you do not expect them to stand up rigid under all stress and don't regulate in the context of that type of belief, I think we are OK.

In other words, if we are skeptical about how firewalls will behave under stress, that is good, not bad, because that means recognizing that we then make certain that our regulatory insights and structures that we put in and requirements of individual institutions take that possibility into question.

So I would say that firewalls are useful to have in the legislation, provided that you recognize that they will not stand up fully, rigidly, even though they will be sort of squishy and they will be of some help, but not as much as one thinks that the analogy to the literal firewall in a building is.

But I do think that the crucial issue the we have confronting us in any of these types of legislative initiatives is to make certain that the taxpayer is not at risk, and that is something which involves both the structure and regulation and what we——

Mr. ORTON. I know my time is expired, but I would hope you would at least respond to the broader question as to your comfort level of the resources, the technology, the manpower and so on to regulate those expanding, broader concentric circles.

Mr. GREENSPAN. I see no significant difficulty involved in the types of changes that are, for example, involved in the Chairman's bill. I am a little hesitant in going further, not because I have any real concerns about going further. It is more of a resources question and an issue of going a step at a time to make sure we have checked out to make sure that the taxpayer and the safety net is not at risk.

Mr. ORTON. Thank you, Mr. Chairman.

Chairman LEACH. Mr. Royce.

Mr. ROYCE. Yes, Mr. Chairman. The D'Amato and Baker bills would allow affiliations between federally insured banks on one side, and commercial firms under a financial services holding company structure.

The Clinton Administration seems to take a compromised position. What they want to do is let banks affiliate with insurance companies as well as securities firms, but not with non-financial commercial companies.

Of course, Chairman Leach's bill will allow affiliations between banks and securities. You've given us your testimony this morning on how you feel and how the Board feels on that approach. My question to you, Mr. Chairman, is what is the Federal Reserve Board's position on banks affiliating with insurance companies?

Mr. GREENSPAN. Let me first say that our general view is that much broader expansion is required in order to prevent the types of problems which Congressman Castle was raising with respect to banks.

Our major concern is that something get done, and our increasing concern is that we may find that we are all in agreement that

we should be between here—we are here now—we go between here and here, and we fail and nothing happens.

So I would basically say that we would essentially be in favor of continuing to open up the system, but concerned that the apparent reasonable consensus that something has got to be done breaks down basically because there are disagreements about specific products, specific firewalls, specific structures. I would hope that, as has been said here earlier, we recognize that there is an increasing broad consensus that something should be done, and we not allow the best to be the enemy of the very good.

Mr. ROYCE. Thank you, Mr. Chairman. I yield back.

Chairman LEACH. Thank you.

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. My colleague, Joe Kennedy, raised a concern that we may be establishing companies that by definition will have conflicts of interests, and in the questioning of Mr. Bachus and Mr. Orton on the firewalls, you said that in crises they may come down, that they're squishy, but we can still regulate to protect them.

What structures would you put in place to prevent these conflicts of interests? Another question is, can you explain the benefit of creating a holding company that has to be so closely monitored because of its inherent conflict of interest?

Mr. GREENSPAN. Congresswoman, would you give me an example of a conflict of interest? I'm not sure I understand that.

Mrs. MALONEY. There have been numerous ones. Mr. Kennedy gave one example earlier of a conflict of interest between the two companies. On Wall Street, you are continually reading about various investigations of alleged conflicts of interest, and particularly when you put the adverse companies together that, quote, "need these firewalls."

Mr. GREENSPAN. I guess I would not call them conflicts of interest. I would say that there are difficulties in bringing certain cultures together, and there are issues where we want to make certain that individual institutions do not use taxpayer funds for inappropriate investment activities.

For example, we think that the subsidies implicit in a bank's cost of capital, which is the result of the fact that it has got deposit insurance or other elements of the safety net, we think one should be very careful about how one exposes the taxpayer to excessive use of subsidized funds.

In that regard we certainly want to be very careful in making certain that the legislative structures that are built do not violate that regard.

I must say that there is a sensitivity, as best I can judge, in all of the bills, especially the Chairman's bill, to the particular question. I don't envision any particular problems that we don't already confront occurring as a consequence of these new legislative structures.

Mrs. MALONEY. There are numerous examples of diversified firms failing to achieve their goals. To cite a few: GE Capital Corporation and Kidder Peabody, American Express and Shearson Lehman. It seems to me that there is a great deal of evidence that when a company gets into a totally new kind of business, the re-

sults have been less than encouraging, to use those two examples. You could use Sears, Dean Witter, All State.

What evidence can you offer to the contrary?

Mr. GREENSPAN. In a market system there are a lot of initiatives which fail. In fact, that is good, not bad, in the sense that if everybody succeeded in doing everything, you would have to question what the system is doing. So, I mean, there are going to be investments that don't work. I think we keep trying until we find the best ones.

The evidence that the system works is that the financial system has been improving dramatically over the last decades. The efficiency has improved, the quality of the products conveyed to consumers, the control of the system has improved.

To be sure, there are various different types of initiatives which fail. The vast majority have obviously succeeded, or else we would not have found the significant improvements in the system that we have seen over the last several decades.

Mrs. MALONEY. While consolidation of corporations may provide for a better or more streamlined organization, the merger between Chemical Bank and Manufacturer's Hanover was very successful, but it did cost a great deal of jobs in New York City.

Can you provide or have you thought about or could you estimate the number of jobs that could be lost in the financial services industry that is likely to occur if we allow affiliation of banks, securities and insurance?

Mr. GREENSPAN. Actually, the financial service industry has been a job creator for a good period of time.

Mrs. MALONEY. But in the consolidation there has been a loss of jobs.

Mr. GREENSPAN. True, true.

Mrs. MALONEY. You are proposing consolidations.

Mr. GREENSPAN. The problem basically is that there are, in any dynamic industry, jobs lost and there are jobs gained. That is the process by which the system moves forward. The question is to see whether or not the gross gains are larger than the gross losses, and that has been the case.

I don't think we should be focusing on how do you prevent restructuring from losing jobs. That is the way productivity advances. What you want to focus on is, where people's jobs are lost, how you get them retrained into more productive endeavors, because that has been the process by which our society and our economy has grown, and our productivity increases decade by decade, so that is not a process that we should try to inhibit.

I think that any organization or any society which tries to inhibit the modernization that occurs as a consequence, that endeavoring to stop that stops rising standards of living. I think that is bad, not good.

Our focus should be, how do we get people who are involved, unfortunately, in these positions into new jobs that are paying jobs, and over the long-run to have jobs that are better.

Mrs. MALONEY. My time is up.

Chairman LEACH. Thank you, Mrs. Maloney.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. Mr. Greenspan, there has been very little grass growing on the path between your office and Capitol Hill this fall—rather, this winter—and I do appreciate your willingness to come and testify before us.

I have been sitting in this hearing listening and learning from my colleagues' questions, and I have no questions for you at this time.

Thank you.

Chairman LEACH. I'm sorry. I didn't follow you.

Mrs. KELLY. No questions. [Laughter.]

Chairman LEACH. Well, we appreciate your thoughtfulness in being a good listener, which we all aspire to and seldom achieve. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Mr. Greenspan, actually this is a follow-up with Congresswoman's Maloney's comments and what you had to say.

As we go through this reform process, I think we will find where you had the situation with GE and Kidder and the long situation with AMEX or American Express and Shearson and Lehman, I think we will find if we allow the merger of commercial banking and investment banking that you will find there are a number of commercial banks who think they want to be in the investment banking business, who probably in the end will find out that they don't want to be in this business: that the lure may be great initially, but then they will find that they will have to cut their losses.

I have a couple of questions for you, and I have a statement that I would like to submit for the record, but I have a couple of questions.

The first is that we've had a lot of discussion about functional regulation, with the Chairman's bill and Mr. Baker's bill and the other bills having various ways of regulation. I am curious whether or not we should be considering going through this whole process, the whole regulatory make-up the financial industry.

I know you've had some pretty hard views on that in the past when proposals have been put forth in the past.

Do you think that is something we should also be considering? The bills address that, but should we be going further or should we structure a final legislation which allows for a later Congress to come in and consider whether or not our regulatory make up of the financial services industry has outdated itself?

Mr. GREENSPAN. I do think that when in the past the issue has come up of regulatory consolidation, there was always the question raised which I thought was really quite appropriate: How do you know how you are going to want to regulate until you know what you've got to regulate?

So I think what we're probably finding at this stage is that we are putting the cart before the horse, and it is far more important that we know what type of industry structure we have before we contemplate how it should best be regulated.

So I should think that if one version or other of the various different types of bills which have been discussed finally passes the Congress and gets signed into law, I think at that point it would be very worthwhile to then relook at what type of regulatory structure we have to make certain that we, in fact, are sufficiently mod-

ernized so that it captures the change in the structure that we just implemented.

Mr. BENTSEN. Thank you.

My other question relates to something that—I don't know if it has been discussed today or not, and that is the Community Reinvestment Act. Let me preface this by saying, one, I do think we need to move forward on Glass-Steagall reform. I think Congress is way behind the marketplace, as you've stated as well, and I don't see the CRA as an impediment to that.

The question that I have, and this relates also to our regulation, it seems to me, one, if Congress does get a bill adopted, that we will have a lot of merger activity going on in the marketplace, and that will bring about review for CRA purposes.

My experience has been that Congress has never fully defined what CRA standards are or are not. The regulators have had to come in, in my opinion, and say, we know what it is when we see it and we will apply it accordingly.

I support CRA. I support some form of it. I know the past Congress took a look at it. I'm sure this Congress will also, but do you think that is something we need to take into consideration as well as we go forward?

Mr. GREENSPAN. I don't think it is really necessarily germane to the Glass-Steagall operations because basically CRA refers to the underlying depository institutions which are being restructured in these financial services holding companies, but not changed as their institutions as such.

So I don't deny that it is worthwhile to review CRA and other aspects as I in fact argued in a hearing very recently. I think it is worthwhile reviewing all legislation that we have gone through periodically to be sure that it is appropriately evaluated, but I don't see—at least it doesn't strike me that it is interrelated with this particular type of discussion and would prefer that would be handled on the side.

As far as I can see, I don't see how CRA gets changed at all if the Chairman's bill is implemented. Now I may be missing something, but off the top of my head I can't see that that should have anything to do with it.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mrs. ROUKEMA. Mr. Chairman, if the gentleman would yield just for one moment, both those questions he asked relate directly to our subcommittee jurisdiction, and we do have—I agree, first of all with the Chairman. I don't think the CRA has any relationship to Glass-Steagall; at least I would think it would be non-germane. However, there are certain outstanding questions that have come up and have been raised under CRA, and we have some hearing scheduled later in March.

Mr. GREENSPAN. March 10.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I believe it is March 10.

With respect to regulatory consolidation, that subject also will be coming up. I think with or without Glass-Steagall reform that may bear some review.

Mr. BENTSEN. If I might, Mr. Chairman, explain my point with relation to CRA. I understand that it is not specifically germane to

Glass-Steagall, but I guess the point I am trying to make is if we move forward with Glass-Steagall reform, as I think we should, we may have more consolidation going on, and CRA I think does become an issue at that point in time.

I would hope that we would just move forward to try and work on that problem.

Mrs. ROUKEMA. We can pursue that in the hearing in March.

Mr. BENTSEN. Fine.

Chairman LEACH. I would just make one CRA observation before turning this to Ms. Roybal-Allard, and that is that to the degree that banks shrink, a lower asset base is covered by CRA, so the degree that giving banks the opportunity to participate in more markets allows them to expand the asset base that is covered by CRA.

Ms. Roybal-Allard, please.

Ms. ROYBAL-ALLARD. Mr. Chairman, a number of observers of the financial environment have argued that there is a difference between limiting the opportunities for risk taking and limiting the incentive for risk taking: The discussion surrounding the repeal of the Glass-Steagall Act so far has focused on limiting opportunities for risk taking.

It is this sole focus that some say is the basic problem with the firewall concept because it does not address the issue of the temptation to take risks. Could you comment on that and perhaps elaborate on how we would deal with the issue of temptation to take risks?

Mr. GREENSPAN. I think that the purpose of the regulatory structure, if we are trying to protect, as we are, a taxpayer-funded safety net, is to try to recognize what types of perverse incentives could be created which would threaten the Bank Insurance Fund, for example.

I think that we've got that problem now. It is not necessarily associated with this discussion of Glass-Steagall reform. It is a difficulty that we have, and it gets to the issue of all different types of products which are involved in commercial banks now, which are basically insured institutions.

It is one that I think we've sort of moved back and forth from, that it used to be many years ago that if a bank had anything with a maturity of more than 90 days, it was perceived to be at risk.

Now we have obviously far greater maturities. We have commercial mortgages, term loans, all in the context of an insured institution; and one of the issues that we regulators have been involved with is to try to evaluate what types of risks various different types of products have for the safety net.

I don't think that is going to change materially with any of the legislation we are talking about today, neither make it more difficult nor more easy, but I do think we have to be aware of the fact that if you have a portfolio which is excessively risky in an insured institution, you are putting taxpayers at risk. I think that is inappropriate.

Ms. ROYBAL-ALLARD. Is that, in and of itself, a deterrent?

Mr. GREENSPAN. Is a deterrent?

Ms. ROYBAL-ALLARD. Yes.

Mr. GREENSPAN. Well, the deterrent is the regulation and the supervision and the capital requirements that we require in order to

be involved in various different types of activities, and the basic purpose of it is not so much a deterrent; it is a question we are basically saying if you get into this type of activity, you better have enough capital to prevent losses impacting on the taxpayer.

Ms. ROYBAL-ALLARD. But if they don't and the deposits are federally insured, then we end up bailing them out?

Mr. GREENSPAN. That is what we are trying to avoid.

Ms. ROYBAL-ALLARD. Right.

Mr. GREENSPAN. We should not have to be in a position of bailing any of these institutions out, and the way to prevent that is to make certain they have enough capital to basically balance the risks they insist upon taking and which they can do legally.

Ms. ROYBAL-ALLARD. OK. I apologize if this question has already been asked in some form or another, but under the repeal of the Glass-Steagall Act, banks will benefit by expansion, and the tendency would be for the bigger banks to serve the most profitable areas.

What mechanism should be put in place to assure that urban and minority communities, such as the one that I represent, continue to be serviced?

Mr. GREENSPAN. First of all, it is not self-evident to me that a lot of these institutions which think they are going to get into securities are going to make a lot of money at it. It is a highly competitive business.

I think it is necessary for them to have the product lines which basically enable these larger institutions to keep their customers and have adequate amounts of products to offer them, but I don't perceive it, frankly, as that necessarily all of a sudden something is going to happen and the profitability of these institutions is going to rise materially. I don't think that is the case.

What we are trying to do is prevent the rates of return and the productivity of financial services embodied in commercial banking organizations from going down. It is not an issue here of opening up something and everyone is going to make a lot of profit. That I don't see happening.

I also don't see happening any material change in those institutions which do not choose to be involved in some of these other products.

As I indicated to one of your colleagues earlier, my own view is that community banks have got highly competitive special niches in our society which are very important to our financial system. It is very difficult for larger institutions to compete with them, and I think that is good, not bad.

So I don't perceive that any of this type of regulatory reform or financial structure change really materially focuses on these types of institutions or impairs their efficiency in any way that I am aware of.

Ms. ROYBAL-ALLARD. Thank you.

Chairman LEACH. Mr. Chairman, we thank you very much for your presentation this morning. I would like to make one request. I understand that the Federal Reserve has some statistics on application processing times. If you would like to present that for the record, we shall be very appreciative.

Mr. GREENSPAN. I should be very glad to do so.

Chairman LEACH. Thank you. And we thank you very much for a long morning.

The following information was subsequently submitted by Chairman Greenspan.

The Federal Reserve last year acted on 3,574 applications and notices filed by bank holding companies and State-chartered member banks. The total number of applications increased by 28 percent over 1993, with notices to establish branches accounting for almost two-thirds of the increase.

The Federal Reserve maintains target dates and procedures for the processing of applications filed under the Bank Holding Company Act, the Bank Merger Act, or the Change in Bank Control Act. The time allowed for a decision is 60 days after acceptance of an application. In 1994, action was taken on 94 percent of all applications within the established time frame. Delays in completing background checks, and extra time required to investigate questions raised about compliance and performance with regard to relevant laws and regulations accounted for a majority of the applications that were not processed within the target time frame.

On average, the 3,574 applications and notices were processed in 33 calendar days from the date of acceptance and 58 days from the date of filing, an improvement from 41 days and 66 days, respectively, in 1993. The average total processing time for international applications improved from 186 days in 1993 to 149 days in 1994, and the average total processing time for domestic applications improved from 63 days in 1993 to 55 days in 1994.

1994 Performance of the Federal Reserve in Processing Applications and Notices

Filed by Bank Holding Companies and State Member Banks

Type of application or notice	Filed	Accepted for processing		Decided		Decided within 60 days of acceptance	
		Number	Days since filing, average	Number	Days since acceptance, average	Number	Percent
Domestic	3,885	3,564	24	3,478	31	3,294	95
BHC formations	385	314	29	298	32	289	97
BHC/SMBK mergers and acquisitions	601	541	27	528	35	501	95
BHC nonbank acquisitions	908	810	28	777	39	711	92
BHC/SMBK changes in control	209	173	8	167	46	152	91
Other SMBK actions	1,550	1,502	21	1,491	22	1,437	96
Other BHC actions	232	224	30	217	37	204	94
International	101	101	50	96	99	70	73
Total domestic and international	3,986	3,665	25	3,574	33	3,364	94

Chairman LEACH. This part of the committee discussion is ended and we will now welcome our next panel. I thank all of you for being so patient in waiting your turn. I apologize for the wait.

We have Mr. Eugene Ludwig, the Comptroller of the Currency, Ms. Ricki Tigert Helfer, the Chairman of the Federal Deposit Insurance Corporation, and Jonathan L. Fiechter, the Acting Director of the Office of Thrift Supervision. We welcome you all.

We will begin with Ms. Helfer and Mr. Ludwig and then Mr. Fiechter, and let me say you are welcome to—we will place any of your testimony that you want to summarize in the record. Mr. Ludwig, of course, would not want to articulate the views that are so critical of my bill, and he might want to submit those——

[Laughter.]

Chairman LEACH. I apologize.

Ms. Helfer.

STATEMENT OF RICKI TIGERT HELFER, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. HELFER. Thank you very much, Mr. Chairman, and members of the committee. I welcome this opportunity to testify on structural reform of our financial system and on the Financial Services Competitiveness Act of 1995.

I commend you, Mr. Chairman, for your leadership in giving structural issues the priority they deserve. Structural reform is of great importance to the future of our financial system.

I have prepared a detailed written statement for the record, including a number of appendices that analyze the competitive environment for banking in the United States and abroad, the volatile swings and the health and performance of the industry that may have resulted from legal constraints that limit the ways in which banks can generate profits, and historical evidence that suggests that the expressed concerns leading to restrictions on the combination of investment and commercial banking in the Glass-Steagall Act were overblown when compared with the remedy.

In the interest of time, I would like to submit my written statement for the record, and I will summarize that today.

I want to stress four points.

Point number one, the Federal Deposit Insurance Corporation has supported repealing the Glass-Steagall Act and the restrictions on the securities activities of commercial banks since 1987, and it continues to support that position.

Point two, the FDIC, as insurer of bank and thrift deposits, has special concerns regarding how these restrictions are repealed. The integrity of the deposit insurance funds requires that repeal be accompanied by adequate safeguards. The Financial Services Competitiveness Act recognizes the need for such potential protections.

Point three, we should proceed cautiously and incrementally in easing restrictions on banking organizations. Before allowing broader affiliations with firms exposed to a different range of nonfinancial risks, we should first develop a body of experience to evaluate the safety and soundness implications of new financial affiliations.

The last decade has revealed that the art and business of banking is difficult. Recognizing that thrifts have had generally positive experiences in affiliating with commercial firms which have in some cases provided much needed capital in times of stress—other experiences of the thrift industry over the last decade argue the dangers of "learning curve" risk. Banking organizations have expertise in managing financial risks such as credit risks, market risks and interest rate risks, but generally have much less experience with respect to non-financial risks.

Point four, there are two organizational structures with which we have experience in the United States that can be used to combine commercial banking and securities underwriting activities, the holding company model and the bona fide subsidiary model.

As my written statement discusses in detail, there are advantages and disadvantages to conducting securities activities in either. To name one advantage of each: While the holding company structure is probably a marginally better model for maintaining the corporate separation of an insured bank from its securities affiliate,

the bona fide bank subsidiary model lets the bank, rather than the parent holding company, control the allocation of the organization's excess capital, which may result in greater weight being given to the needs of the bank.

Banks have had experience conducting securities activities through both structures with few problems. Weighing the benefits and costs of each structure, I favor allowing financial institutions to choose the model that best suits their business needs as long as strong safeguards are in place to protect the insurance funds.

In particular, the restrictions of section 23A and 23B should apply fully, regardless of whether the securities affiliate is a subsidiary of the financial holding company or the bank, or whether it is the parent of the bank.

Moreover, there should be limitations on the way in which an insured bank can fund, directly or indirectly, the securities activities of affiliates, in general, only from excess capital; that is to say, capital over and above that required for a well-capitalized bank.

I will discuss points one and two again briefly. Repealing Glass-Steagall restrictions would strengthen banking organizations by allowing them to diversify their sources of income.

Repeal would allow banks to serve their customers more effectively, and would promote an efficient and competitive evolution of U.S. financial markets.

I would like to highlight just one argument in favor of repeal of Glass-Steagall restrictions from the perspective of the insurer—making banking more competitive may also make banking safer.

Large corporations meet their funding needs by issuing commercial paper, debt securities and equity securities and by borrowing from banks.

Glass-Steagall restrictions prevent most banking organizations from providing the full range of funding options. Further, bank lending to large corporations has been declining for decades. The percentage of the liabilities of non-financial corporations that bank loans represent declined from about 22 percent in 1974 to 13.5 percent in 1994, the lowest percentage registered since these data began being collected in the early 1950's.

Is it surprising then that banks have grown much less rapidly than other financial intermediaries during the past 10 years? For example, during this period, banking assets grew at an average annual rate of 4.9 percent compared to growth rates of 28.7 and 19.8 percent for mutual funds and securities firms respectively.

As my written statement discusses, there is indirect evidence to suggest that as banks have lost their best business customers, they have turned, to some extent, to riskier ventures such as construction finance and commercial real estate lending.

Rather than making banking safer, it appears that Glass-Steagall restrictions have had the unintentional effect of making it riskier. Clearly, there is a need to repeal these Glass-Steagall restrictions.

In doing so, however, safeguards are necessary to protect the deposit insurance funds and the financial system. Recent experience illustrates why safeguards are absolutely necessary.

From 1985 to 1994, the FDIC's Bank Insurance Fund, and by extension the banking industry, spent almost $33 billion to resolve

bank failures. It has been estimated that resolving the thrift crisis cost $150 billion, largely paid for by the taxpayer.

The experience of the thrift industry in the 1980's offers a stark illustration of why it is important to maintain safety and soundness standards when expanding lines of business for insured institutions.

Federal legislation in the early 1980's significantly liberalized the type of assets that thrifts could hold. By 1982, thrifts that were experienced with residential mortgages could make commercial mortgage loans up to 40 percent of assets, consumer loans up to 30 percent, and commercial loans and leases each up to 10 percent of assets.

By midyear 1983, federally-chartered savings and loan associations were allowed to invest up to 11 percent of assets in high-risk bonds. Direct equity investments in real estate, equity securities and subsidiary service corporations were also permitted up to 3 percent of assets, and several States permitted State-chartered institutions significantly greater scope for direct investments. These percentage of asset limitations were generally equal to, or multiples of, thrift capital.

The attempt by many troubled institutions to use the new powers to "grow themselves out of their problems" added substantially to the cost of the thrift crisis. On a smaller scale, when a number of bank holding companies came under severe financial stress in the last decade, "deathbed" transactions with insured bank subsidiaries resulted in material losses to the deposit insurance funds.

Some of the most troubling examples of inappropriate transactions among affiliates came in fact from the thrift industry of the 1980's. With the liberalization of Federal and State restrictions on direct real estate investment in the early 1980's, the real estate development subsidiary became a common vehicle.

Under State laws, State-chartered institutions in California and Texas could make virtually unlimited direct real estate investments. Two factors made this liberalization of powers particularly conducive to creating losses for the Federal Saving and Loan Insurance Corporation and the Resolution Trust Corporation.

First, under regulatory accounting practices, direct investments in subsidiaries were carried on the books of the parent thrift at historical cost, instead of market value, which was often considerably lower.

Second, thrift regulators as a rule did not conduct detailed examinations of subsidiary operations. Under these conditions, thrift managers were free to invest in real estate development activities with which they had little experience, and when things went badly they used a variety of transactions to hide the losses.

The thrift could make unsound loans to help sell new properties built by the subsidiary, and in some cases the thrift would sell the note to the subsidiary, removing it from the balance sheet to escape scrutiny.

Mr. Chairman, the lesson of the last decade for bank supervisors is to remain vigilant. Banking organizations have had some experience with securities activities, largely through foreign subsidiaries of U.S. banks regulated by the Federal Reserve, through the Federal Reserve's section 20 subsidiaries of bank holding companies

and, on a more limited basis, through the FDIC's bona fide subsidiaries of banks.

These activities have generally not resulted in losses to the insurance funds. It is our responsibility to ensure that reform of Glass-Steagall does not make losses more likely.

Our experience has been that while existing protections are generally adequate, the regulatory community has, on occasion, been reluctant to enforce these protections to the fullest extent, especially when institutions are under stress.

With the repeal of Glass-Steagall restrictions, the enforcement of safeguards against transactions between an insured bank and its securities affiliate should allow for few exceptions.

Congress should consider whether the perspective of the FDIC as insurer would be useful in identifying through guidelines or other means those limited areas where exceptions to the safeguard could be made without adding to the risk of losses to the insurance funds. Here I am speaking in particular about waivers of the restrictions of section 23A and 23B on affiliate transactions. The FDIC is prepared to report regularly to our sister regulators on instances where affiliate dealings caused problems for insured banks and produced losses to the insurance fund.

Finally, I support clear mandatory disclosures that securities offered or sold by a securities affiliate are not federally insured deposits. This protection is necessary for the investors and the deposit insurance funds.

In conclusion, Mr. Chairman and members of the committee, with the safeguards to protect insured banks and the insurance funds that are discussed in detail in my written statement, repeal of the Glass-Steagall Act will strengthen the financial system and will enhance the ability of banks to serve their customers.

The time has come to move ahead. The FDIC stands ready to assist the committee with this important effort in the weeks and months ahead.

Thank you, and I look forward to responding to your questions.

[The prepared statement of Hon. Ricki Tigert Helfer can be found in the appendix.]

Chairman LEACH. Thank you, Ms. Helfer.

Mr. Ludwig.

STATEMENT OF EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY

Mr. LUDWIG. Thank you, Mr. Chairman, for the opportunity to discuss H.R. 18, the Financial Services Competitiveness Act of 1995. I want to first commend your leadership in so quickly offering this initiative to modernize our financial services system, and I also applaud Representative Baker for his thoughtful proposal. I have more detailed written comments that I would like to submit for the record. Let me summarize my remarks here.

We all share the desire to give America a truly competitive financial services industry that offers a range of products and services, is more efficient, and is even more capable of fueling the country's economic growth.

Last year we took a major step forward by removing the barrier that limited a bank's ability to diversify geographically. Activities

diversification is the second cornerstone of a vigorous modernized banking system, and it is equally important to serving communities and competing in international financial markets.

The Secretary of the Treasury has announced several concepts toward legislation in this area, and I support his approach. As we work together to modernize the financial services system, any reform proposal must achieve three objectives.

First, we must maintain the safety and soundness of the banking system. This requires a balance between prudential safeguards and enhanced activities flexibility, coupled with sound supervision.

Second, a new system should encourage healthy competition and efficient business operations to benefit all consumers of financial services—in all of our communities—and thereby facilitate economic growth.

Third, regulation—and regulators—must be both effective and efficient. Banks should have substantial freedom to choose the organizational form that best enables them to respond to marketplace demands, absent compelling public policy reasons to limit that freedom.

Allowing banking organizations to expand their activities into investment banking will reap benefits for customers of all types and sizes, and nowhere will this be more apparent than on "Main Street America." Current restrictions deny a local business the option of working with a lender who has come to know and understand its business over the years. Reform can give these businesses the benefits of price competition, which can lower their financing costs and introduce them to a variety of innovative financing approaches.

Further, at a time when all levels of government are looking for ways to deliver essential services in the most efficient way, we can help state and local governments lower their costs by allowing national banks to compete for the business of underwriting their revenue bonds. The economic boost that competition provides can mean increased jobs and deeper capital markets.

However, I say all of this with one important caveat. These benefits will not be realized unless new entrants can compete effectively. It is not enough to allow a bank to undertake new activities if in doing so we also impose so many unnecessary regulatory burdens that we lose the benefits of diversification. In dismantling the Glass-Steagall wall, we must not leave so much regulatory barbed wire in its place that we defeat our common objectives.

This leads me to two fundamental concerns about H.R. 18. First, H.R. 18 relies too heavily on organizational structure and transactional firewalls as supervisory devices to shield institutions from the perceived risks of expanded financial services activities. The bill allows broader securities activities to be conducted by banking organizations, but, with one exception, only through a bank holding company affiliate.

Second, H.R. 18 shifts new financial services activities—and even some traditional ones—from banks and their subsidiaries to holding company affiliates. Safety and soundness considerations do not require this surgery. The long-term health of the economy and the banking system depends on banks' abilities to remain strong and innovative financial services providers in their own right.

The bill would prohibit other structural options, potentially more efficient or better suited to a particular banking organization, such as the use of bank subsidiaries. In addition, if banks wished to engage in broader securities activities, they would have to discontinue activities that are customary, profitable, and that have not been the basis for safety and soundness concerns, such as securitizing and selling their loans. They could no longer participate in financial market innovations because they would be barred from underwriting and dealing in any securities other than those listed by statute. and banks would have to stop their private placement services for institutional customers.

H.R. 18 also contains extensive firewalls that separate a bank and its securities affiliate to such an extent that it impairs reasonable opportunities for synergies. Certainly, when applied to certain kinds of activities, firewalls along the lines of sections 23A and 23B of the Federal Reserve Act and separate capital requirements can play a useful role in reducing a bank's exposure to risk, protecting against conflicts of interest and preventing consumer abuses. But we should also be realistic about their shortcomings.

We need not depend upon rigid structural devices to protect against risk because there is a better alternative. The combination of effective supervision and flexible firewalls can deliver the safety and soundness we need without excessive costs. This approach allows the regulator to tailor risk management to the peculiar risks presented by a new activity as it is conducted by a particular bank in light of current economic conditions.

My second concern is that H.R. 18's imbalance in favor of activities conducted in holding company affiliates rather than bank subsidiaries could increase risk and sap the vitality of our banking system. Limiting activities can make banks riskier for several reasons. First, it deprives them of benefits of diversification, locking them in to one set of risks. Second, it prevents banks from evolving beyond a narrow market segment, impairing their ability to continue to do a safe and profitable business. Third, limiting activities drives away a bank's better customers, making even their traditional activities less safe. As competitors rush to develop new products and compete aggressively for bank customers, banks and their subsidiaries need the ability to provide products to respond to market demands.

The long-term viability of our banking system depends upon the ability of banks, directly and through their subsidiaries, to be strong and competitive financial providers in their own right. Unless compelled by reasons of safety and soundness—which I do not believe is the case for securities, insurance and many other financial activities—banking organizations should be allowed to innovate, either through holding company affiliates or bank subsidiaries. The market should be free to make its own structural choices to maximize operational efficiency and minimize risks.

Empirical evidence suggests that non-traditional activities need not threaten bank safety and soundness. U.S. banks, through foreign branches and subsidiaries as well as holding company affiliates, have successfully engaged in a variety of non-traditional activities abroad for many years. Further, banks in most developed countries have been engaging for many years in the type of new ac-

tivities specifically referred to in H.R. 18. Finally, U.S. banks have been underwriting general obligation bonds for years.

You have also asked me to comment on the issues involved in permitting commercial firms to own banks. Clearly, the health and competitiveness of U.S. banking may at some time come to depend on our willingness to modify this separation. But I would urge that we first focus our attention on the universe of financial activities because the potential is greater, the benefits can be more immediate, and the risks are better understood.

In conclusion, I would like to emphasize the importance of these hearings. I would like to once again commend you, Mr. Chairman, and you Mr. Baker, for your leadership. I thank you and welcome your questions.

[The prepared statement of Hon. Eugene Ludwig can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Ludwig.

Mr. Fiechter.

STATEMENT OF JONATHAN L. FIECHTER, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. FIECHTER. Thank you, Mr. Chairman, members of the committee, for the opportunity to present the views of the Office of Thrift Supervision on H.R. 18, the Financial Services Competitiveness Act of 1995.

H.R. 18 raises important questions regarding the scope of activities that banks and thrifts should be permitted to engage in, both directly and indirectly.

As the Chairman noted when introducing H.R. 18, the marketplace has changed significantly since the Glass-Steagall Act was enacted over 60 years ago. The introduction of new financial products, technological advances and dramatic changes in the way households and corporations manage their finances have resulted in a shift away from traditional financial intermediaries. The distinction between banks and non-banks engaged in financial mediation has blurred.

By seeking to preserve a compartmentalized set of financial institutions, the Glass-Steagall Act has restricted the ability of U.S. financial intermediaries to respond to market forces. This is clearly an area where the law has lagged behind the market.

There have been a number of initiatives over the years to expand bank powers. These initiatives typically have sought to balance three competing objectives: the need to maintain a safe and sound insured depository system, the need to ensure stable, competitive, efficient and responsive financial markets, and a desire to provide maximum operational flexibility so that various banking and nonbanking financial services could be bundled and offered in an efficient and profitable manner.

Your bill, Mr. Chairman, would give bank holding companies important new authority to engage in investment banking and allow investment banks to acquire commercial banks.

The scope of permissible activities of thrift holding companies, however, would be sharply curtailed. In assessing how much flexibility is appropriate, it may be helpful to consider the experience

of thrift holding companies, which, unlike bank holding companies, have historically been given broad powers.

The experience of OTS in regulating these thrift holding companies has, on the whole, been positive. The range of permissible activities of thrift holding companies is governed by the Savings and Loan Holding Company Act of 1967. Under this act, holding companies that own a single savings and loan are permitted to engage in any activities that do not threaten the safety and soundness of their subsidiary saving association.

When Congress amended the Bank Holding Company Act in 1970 to impose restrictions on unitary bank holding companies, it did not place additional restrictions on the unitary savings and loan holding companies.

This may have been due to the focus of thrifts on residential lending. Thus affiliations between saving associations and companies engaged in financial and other commercial enterprises do not present the same potential for concentrations of economic power.

Companies owning savings and loans, however, must comply with a variety of strict statutory and regulatory requirements and restrictions. Thrift holding companies must undergo regular OTS examinations, usually concurrent with the examination of their subsidiary thrifts.

OTS examinations of holding companies focus on transactions between holding companies and their savings associations, funds flowing from savings associations to their holding companies, the quality of holding companies' management and the extent of management's participation in and oversight of thrift decisions, and the financial impact, if any, of the holding companies' operations on the subsidiary thrift.

Taken together, the supervisory strategies and other safeguards have worked well to prevent the types of systemic abuses that motivated passage of the Glass-Steagall Act and the Bank Holding Company Act. Because of the current broad powers authorized by the Savings and Loan Holding Company Act, the impact of the H.R. 18 on thrift holding companies would be quite different than on bank holding companies.

For bank holding companies, H.R. 18 would grant important new powers. For companies seeking to purchase savings associations, however, H.R. 18 would significantly restrict powers. H.R. 18 would limit the activities of new thrift holding companies to those that have been approved by statute for multiple thrift holding companies and any activities approved for bank holding companies. As amended, these restrictions would apply to thrift holding companies formed after January 4, 1995.

Going forward, companies engaged in commercial, industrial and certain financial enterprises could no longer acquire savings associations. In addition, savings associations that are not now owned by holding companies, which represents almost two-thirds of all savings associations, would be precluded from forming holding companies that engage in these activities.

The roster of thrift holding companies includes many small holding companies engaged exclusively in activities closely related to owning and managing a subsidiary thrift. It also includes multi-billion dollar companies engaged in diverse financial, commercial

and industrial activities. In between are numerous medium-sized companies that engage in a few select diversified activities.

There certainly have been occasions when thrift holding companies, along with their subsidiary thrifts, have violated the law and otherwise engaged in unsafe and unsound practices that required enforcement action. We have not, however, detected any systemic problems that arise as a consequence of the scope of permissible activities of thrift holding companies and their affiliates.

In our experience, thrift holding companies that engage in diverse activities do not raise supervisory concerns with greater frequency than thrift holding companies that confine their activities to those permissible for bank holding companies; nor have we seen evidence in the thrift context of the type of systematic abuses that motivated enactment of the Glass-Steagall Act and the Bank Holding Company Act. We attribute this to the many safeguards that regulate interaction between savings associations and their holding companies and perhaps also to the unique nature of the thrift business with its focus on residential mortgage lending.

Affiliations between savings associations and companies engaged in financial, commercial and industrial activities have had three primary benefits.

First, thrift holding companies that engage in diverse lines of business often have substantially greater financial resources than non-diversified companies.

Diversified companies have infused several billion dollars in equity capital into savings associations. These infusions of capital have decreased taxpayer exposure to Federal deposit insurance losses.

Second, although less quantifiable, diversified companies can contribute business and managerial talent and expertise to their subsidiary savings associations. This is especially true when holding companies have significant experience in financial services activities.

Third, when savings associations affiliate with holding companies engaged in providing financial services, the savings association, its holding companies, and its customers all benefit. Customers benefit when they are able to do business with an integrated financial services company.

I believe that the experience of thrift holding companies provides concrete evidence that depository banking activities and other financial services can work together in a safe and sound manner provided adequate safeguards are established.

Savings associations have long been affiliated with other financial and commercial firms without any adverse systemic repercussions. Indeed, these affiliations have often proven beneficial to the thrift and to their customers.

For these same reasons I also urge that companies owning savings associations not be stripped of their statutory authority to engage in other financial activities in various commercial and industrial activities.

At a time when both the Administration and Congress are committed to reducing regulatory burden, H.R. 18 raises the question of whether thrift holding companies should be subjected to new government restrictions. If the benefits of the thrift charter con-

tinue to be eroded while all the unique restrictions and costs that the government places on the thrift charter are retained, it will become much more difficult to attract capital to the thrift industry. This would be especially unfortunate at a time when the thrift industry is facing an uncertain future.

The dramatic expansion of the government-sponsored secondary mortgage has narrowed interest margins on conventional fixed rate mortgages, a major product of the thrift industry. The significant financial burdens imposed directly and indirectly on surviving savings associations as a consequence of FIRREA have further reduced profitability. Well-capitalized and well-managed savings associations are facing deposit insurance premiums six times higher than well-capitalized and well-managed banks.

At a time like this I believe it is beneficial to provide saving associations with continued access to the financial and managerial resources available through broad-based thrift holding companies.

Thank you very much.

[The prepared statement of Mr. Jonathan Fiechter can be found in the appendix.]

Chairman LEACH. Thank you all for very thoughtful and constructive testimony.

Let me first turn to Mr. Ludwig and say that there is a very difficult choice we have to make between authorizing powers within a bank or within a holding company structure.

You have argued to do it within a bank. The reasons that I prefer a holding company structure are partly that it seems self-evident that if you do it within a bank you expand the deposit insurance coverage to all of these activities and I am not so sure that is something Congress would like to do.

Second, it also strikes me that a holding company structure will have the effect of higher capital standards. Although one can say you'll demand higher levels of capital, the end effect of it in most circumstances would seem to cause lower levels of capital for a bank. If you have a bank with a given set of capital ratios and you put it in a holding company structure, the securities affiliated will have to be separately capitalized, which is an easier way of looking at that.

You don't have the tendency to double accounting.

Third, I think we also have to recognize that there are more than simply safety and soundness concerns. As regulators you are interested in safety and soundness, but beyond that there is a competitive coercion implication that many other aspects of American commerce hold toward commercial banks getting involved in these kinds of areas, whether it be first and foremost in the securities industry, where they like to see separately capitalized subsidiaries, they know they are dealing apples to apples. They can see the strength, the world can see the strength of the subsidiary and not get confused that the subsidiary is part of a different structure that might be able to tap into other forms of income or basic strength.

But it goes beyond the securities area. It's securities because we are talking Glass-Steagall, but you have here the implication that there might be more and more activities, and I assure you that there will be more and more kinds of companies that will start to object to a bank doing this internally.

As you know, in small banks there's a lot of allegations that there is coercion in selling insurance. You get a bank involved in areas of information technology that might or might not be considered financial in nature—almost any area, the more you tie it into the bank, the more you are going to have real or perceived coercion alleged by competitors.

I think for the security of the bank in being able to maintain these services as well as gather new ones, it's got to be very clear that they are kept separate.

That is why I strongly prefer the holding company structure instead of expanding the activities permissible within a bank structure.

Beyond that I don't know all the philosophical implications, but you just have to look at the Barings issue of this week. It appears in that situation that within the bank a certain kind of activity occurred for which the bank, and presumably the British Government, may well have to be financially responsible. If that were held in a subsidiary structure—or holding company structure, I don't know if there is a different implication or not but I think it raises analogous concerns internally for the United States.

Anyway, let me just ask you—I'm just laying out the reasons that I differ with you even though I would thoroughly acknowledge it is structurally easier for bank management to handle it within a bank. I think that's absolutely valid. Although I think these can be handled in a holding company structure, there are a few aspects that may be slightly less easy for a bank to manage when the activity is conducted in a holding company structure.

If we think, and it was raised earlier with Mr. Greenspan, of the Continental Bank and the First Options situation, it would strike me that that is another reason why these activities should not be within the bank.

Would you care to comment on that? That was an OCC concern.

Mr. LUDWIG. Yes, sir. Thank you for your thoughtful question. I have given this a great deal of thought, and it seems to me that the first thing you have to look at is what kind of activities we are talking about. If you look at the "new activities" in H.R. 18 on a spectrum of risk, these activities would have to fall by and large on the less risky side of the ledger. That is to say, there are many activities in which banks engage directly today that are far riskier than the kinds of activities that are proposed as new activities under H.R. 18.

Chairman LEACH. With the exception, if I can interrupt you there, there's flexibility granted the Fed to make ongoing definitional changes and so, you know, it's hard to predict the future but in terms of delineated activities, you are certainly partly right.

Mr. LUDWIG. I believe that with regard to new activities one has to make a meticulous review of the specific activity and determine the appropriate supervisory mechanism, that is, firewalls, to maintain the maximum safety and soundness.

Regarding legal liability limitations, whether or not you can pierce through to the subsidiary or the bank holding company affiliate is p question of how the entity is operated, not where it sits e organization.

Indeed, I am sure you have been in bank holding company offices. When you go in these large bank holding companies, you see one door that has X Banking Corporation, another door that has X Banking Capital Entity, and another door that has the bank. You go in the various doors and the back offices are completely joined. There's no real separateness. That wouldn't pass the test that would give you limited liability. The issue is really how an entity is operated. But I don't think there is any distinction from a safety and soundness perspective and from a limited liability perspective as to where in that corporate organization the activity is conducted.

Chairman LEACH. I'm sorry, I have——

Mr. LUDWIG. I could go on for some time, but it sounds like——

Chairman LEACH. I don't want to be unfair to my colleagues and I have more questions and I will ask my other questions after I have turned to them, if that's all right.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Ludwig, I think the discussion about supervisory versus structural changes obviously is something that resonates with the members of the committee. We obviously gave the S&L regulator, the board, some responsibilities in the early 1980's and I think the testimony today again recants the problems with things like direct investment. I think some structure and some capital having the right combination of these as we move into additional powers is very, very essential in this process because there are some contradictions in terms of the various structures.

I must say, Ms. Helfer, Chairman Helfer, that in reviewing the discussion that you have with regards to growth of banks, the lack of growth, the 5 percent through 1984 to 1994, of course it depends what base you start with.

There seems to be a notion here that somehow in the marketplace, and these are questions, are we deficient? Is the system a problem in terms of raising capital?

I know that the governance structure that is involved is important. I think there is some blurring of the lines, homogenization of the products as the Chairman of the Federal Reserve Board has indicated, but I must say I don't know that—I think there are some risks here.

Do you see any risk at all, Chairperson Helfer, in terms of moving—I think you wanted to be called Chairman. Whatever you want to be called——

Ms. HELFER. I'll answer to both names.

Mr. VENTO. But any risks in terms of moving in terms of likely merger of a lot of the investment bankers into banking and the change in terms of if we say all of a sudden you have capital standards, you have other requirements that are going to obviously reflect bank into that particular investment banking, doesn't that change the configuration or freeze in place what we really want to be dynamic in terms of the financial marketplace and not incorporate into a governance structure where we are concerned about capital and deposit insurance and these other aspects which rightly I think my colleague and Chairman is correct to be concerned about.

Ms. HELFER. Well, I think we have to leave to the business organizations in the end whether they would seek an affiliation, in the case of securities firms, with an insured entity realizing that there must be very real separations both in terms of the nature of supervision and in terms of the nature of capital and other protective requirements between the insured bank and the other activities.

As I have pointed out in my written testimony, we have seen in the past at the FDIC problems with both structures. We have seen where a holding company has sought to extract value from an insured bank to the detriment of the insured entity in creating losses to the insurance fund.

We have also seen instances where insured banks have provided funding to subsidiaries in ways that have also been to the detriment of the insured entity, so it is necessary I think to have those protections in place.

Mr. VENTO. I think those examples you have in terms of the tax issues and the computer use and how things were scored and whatnot, my colleagues should look at these comments because I think they are essentially very important.

I think Chairman Greenspan just told us that the firewalls melt in a crisis, so when we are talking about safeguards, Mr. Ludwig, how would you respond to that and others at the table? I mean they melt in a crisis—there are questions here where these don't work when we have the problems. I think Chairman Helfer has indicated so.

Mr. LUDWIG. That is why I would not rely solely on firewalls or corporate structure, and indeed it can hurt us.

One thing I didn't mention that is really quite important is when we look at corporate structure and think of it in a catastrophe mode, we are looking at only one little corner of a very large picture. The very large picture includes the support that the subsidiary operation can offer to the financial well-being of the entire entity to make it competitive.

Mr. VENTO. It covers the diversification issue, yes.

Mr. LUDWIG. Even more than diversification, there is a question of the stream of profits and the capital flowing up to the bank as distinct from simply up to the holding company.

To get to your specific supervisory question, Congressman Vento, let me take the situation of firewalls versus supervision and point out we have really been very concerned for some time about strengthening supervision and in particular management controls. Banks can engage in any activities along a whole broad spectrum of risk. Some activities may seem less risky but in fact if banks engage in them in an aggressive fashion they become very risky. Alternatively, some of the activities that may at first glance appear riskier can be engaged in in a very conservative manner. The question really is to make sure through supervision and through rules and guidelines, tailored to the activity, that the institution engages in the activity in an appropriate fashion, that it manages the risk carefully, and that its control mechanisms assure that those risks are being managed.

Mr. VENTO. Well, Mr. Chairman, my time has expired but I think that to some extent this envisions a degree of regulation that has not existed historically and the comments of Chairman Helfer con-

cerning the seamless nature in terms of the SEC doing its job in the Office of Controller and then you doing your job in terms of insurance and all of this coming together, because clearly, Mr. Chairman and members, you have to know what the capital is. You have primary responsibility to not expose taxpayers, to provide flexibility, but all this has to mesh together in a way that hasn't existed before so I am very concerned about it.

Obviously I don't doubt the good intentions. There are a lot of good intentions in other instances around here where the law of unintended consequences occurred and we went through that, Mr. Chairman. I don't want to do that again. Thank you.

Chairman LEACH. Thank you, Mr. Vento. Mrs. Roukema.

Mrs. ROUKEMA. I am not going to belabor this but my colleague from Minnesota, you mean there are elements of deja vu all over again?

I have belabored that one a long time. No, I am not going to belabor this subject but I just want to concur with some of the questions that have been raised by my other two colleagues.

It seems to me that if I understood Mr. Ludwig correctly, and I think he said something about unnecessary regulatory barbed wire and saying that it relies too much on the regulatory structure and he would rely on rigid supervision, well, that to me lacks credibility in terms of the real world and especially since in the Administration's proposal, as I understand it—and it is only a superficial understanding because we have only just gotten it—it seems to me that it jeopardizes the insurance funds in its organization, as Mr. Leach has outlined here.

It seems to me that that is a given and it expands the liability in the subsidiaries with respect to the insured deposits.

But I don't see any way in the Administration's regulatory structure as I understand it and I think Mr. Ludwig is advancing it that it seems to me that there are large gaps there, so that yes, firewalls may melt, but you can't assume that you are going to have rigid supervision and risk management to substitute for regulatory authority.

I think you need somewhat of a rigid regulatory structure and that doesn't mean that abrogates the responsibility for strict supervision. I think they are both needed here.

Mr. LUDWIG. I would agree with you.

Mrs. ROUKEMA. Go ahead, Mr. Ludwig.

Mr. LUDWIG. Congresswoman Roukema, I would agree with you. I think that firewalls can be useful, as I said in my oral statement. However, they have to be blended with serious supervision. Supervisors must have enough authority to be able to tailor the firewalls so that they can achieve their maximum impact in those areas where there is significant risk.

Mrs. ROUKEMA. You are not suggesting that that would substitute for statutory responsibility? You mean enhance the statutory responsibility?

Mr. LUDWIG. Let me give you an example, if I might.

Mrs. ROUKEMA. Yes, please.

Mr. LUDWIG. In H.R. 18 there are limitations on the degree to which bank funds can be used to support nonbanking affiliates. The 23A and 23B limitations in the Federal Reserve Act are strong,

sound limitations and in the right circumstances make a big difference, in my view. The question is if we are to go beyond that—as H.R. 18 would suggest in some cases—that we tailor the firewalls to the specific kind of activity that the subsidiary or the holding company affiliate is actually engaged in so that we do not overfirewall.

Let me give you an example. The statute provides that municipal revenue bonds can be engaged in by a bank but if the bank has a securities affiliate, the activity would go into the securities affiliate. Do we need to isolate an activity that we have already admitted could be conducted inside the bank with super-strict firewalls, or can we tailor the firewalls in a way that is effective for proper supervision? That is really what I am getting at.

Chairman LEACH. Would the gentleman yield? The Fed does have flexibility to tailor it in that fashion.

Mr. LUDWIG. It does, sir, but the way it is written it really tailors down from the firewalls that are specifically mentioned in the bill as distinct from imposing 23A and 23B restrictions and allowing the Fed to add to those restrictions.

Chairman LEACH. Well, my counsel advises me that that is not the intent and so that is an interpretation that we wouldn't give it, but I just set that out to you.

Mr. LUDWIG. That's helpful to hear.

Mrs. ROUKEMA. Thank you. I think we have covered this amply for the moment. Thank you very much.

Chairman LEACH. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, and first I apologize to the witnesses that I wasn't here to hear their testimony. We had the markup of term limits in the Judiciary Committee down the hall.

OK. I guess I would just like, with Mr. Ludwig here in particular, to reiterate my comments, that, first, I am utterly amazed that the Administration is going along with this subsidiary position.

Second, I respect you, Mr. Ludwig. How you got them to do it is just unbelievable to me and I am hopeful they will back off it because not even the wildest deregulators around here have wanted to see a securities subsidiary of a bank exist.

My basic problem is your view seems to be leave it to the regulators, you'll do just fine, and so you define new types of activities very broadly in the Administration view, incidental to or part of the business of banking. Could a computer firm be incidental to or part of the business of banking? Could an automobile company be—they have big finance companies—be incidental to the business of banking?

You know, most of us sat here through not only the S&L crisis but various crises in the banking industry and frankly I don't have total faith in the regulators. I don't even have 75 percent faith in the regulators and if you look at the history of the OCC, no disrespect to you, the OCC has had numbers of problems throughout the years in terms of regulation, and so here you are telling us that, you know, (a) any types of activities; (b) you don't specify what kind of firewalls. You put the subsidiary in the bank.

To me it is a formula for disaster and I have to tell you I am surprised that the President and the Secretary of Treasury went

along with this formulation. I intend to ask them why they did. They will be here tomorrow, I guess—not the President, thank God, for his sake, but certainly the Secretary.

I am just utterly amazed how in light of all the problems we have in this Brave New World of banking, in light of what happened with Baring you are just saying we'll leave it to the regulators, so I have some specific questions but I'd let you answer that, since it was pretty much a broadside I fired—but I am frustrated.

I am disappointed and I am on the verge of anger at this Administration, which I have been supportive of, for coming up with such an awful plan.

I'd support Baker or Leach more quickly than I'd support the Administration plan, so my only admiration for you is how you got them to do this, because everyone knows that this is your brainchild—but I think they will regret it. You tell me what you think.

Mr. LUDWIG. Though I think it is a good proposal, I can hardly say that it is my brainchild but let me say that I feel pretty strongly on a number of different points here. Number one, it is not any and all activities. The Administration proposal is limited to financial activities. This is not a case, as you allege, and I think the Secretary of the Treasury will make it clear——

Mr. SCHUMER. I haven't seen the details. Doesn't it say "incidental"—"incidental to or part of the business of banking"——

Mr. LUDWIG. I don't blame you for being confused because the Administration hasn't put the whole proposal out.

Mr. SCHUMER. All right, but the OCC proposal clearly had that, said that. Is this going to be scaled back from the OCC proposal?

Mr. LUDWIG. Only financial.

Mr. SCHUMER. What does that mean?

Mr. LUDWIG. You're right to say that the line between finance and commerce, as Chairman Greenspan said, is a hard line to get exactly right, and it changes over time. For example, there are certain data processing information type——

Mr. SCHUMER. Let me ask you specific questions. I'm beginning to run out of time. I'm sorry, I'd allow you to respond in writing.

Would you think it would be permissible when a securities subsidiary of the banking affiliate was pitching an underwriting to a firm that the loan officer from the bank could sit in on the meeting? Would that be OK? Because you don't specify what kind of firewalls.

Give me a yes or no.

Mr. LUDWIG. Actually, if you'll excuse me, we do specify. I said in my oral testimony that I thought 23A and 23B of the Federal Reserve Act and capital——

Mr. SCHUMER. That's just arm's length. I am asking you a specific——

Mr. LUDWIG. No, 23A, excuse me, sir, is not arm's length. That's 23B.

Mr. SCHUMER. All right.

Mr. LUDWIG. 23A is specific restrictions on transaction-related——

Mr. SCHUMER. Would you allow what I talked about, yes or no, under your proposal? Could the loan officer who is making loans to the company sit in on the meeting where the underwriter who

is a subsidiary who might report to that person is pitching the underwriting business?

Mr. LUDWIG. I would reserve the question because I would like to think about it, but I think the answer may well be no.

Mr. SCHUMER. In other words, the regulators would decide under the Administration proposal?

Mr. LUDWIG. Let me say this, when you look at these activities, the question you have to ask yourself primarily is whether these are riskier activities than activities in which banks are currently engaged?

Mr. SCHUMER. But Mr. Ludwig, I don't want a general discussion. I have been through that discussion with you and with many others. I want some specific answers because again this seems to me to be "leave it to the regulators."

That specific issue that I asked you about, which is one of many, as I take it the Administration proposal, 23A, 23B doesn't specifically answer and a regulator would have to decide, is that correct?

Mr. LUDWIG. As to whether or not a loan officer and an underwriter could participate in a particular financing from the same——

Mr. SCHUMER. That wasn't exactly my question. Exactly my question is this: The securities subsidiary of the bank is pitching an underwriting. Could the loan officer who has made loans to that company sit in on the meeting?

Mr. LUDWIG. I will get back to you on that question.

Mr. SCHUMER. OK. Well, I have, you know, a dozen questions like that——

Mr. LUDWIG. I'll get back to you——

Mr. SCHUMER. And the fact that you can't say——

Mr. LUDWIG. On every single one.

Mr. SCHUMER. OK, I thank the Chairman.

Chairman LEACH. But before turning to Mr. Baker I would like to take 15 seconds to get back to you on your one assessment of the meaning of our bill and I would refer you to the bottom of page 5, the top of page 26, and I won't read it but it is very precise. The intent is very clear and it is not exactly as was reflected in your statement.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Before I start any of my questions I would just like to thank Mr. Schumer for his ringing endorsement of my legislative proposal. [Laughter.]

Mr. SCHUMER. You can thank Mr. Ludwig for my ringing endorsement of your legislation.

Mr. BAKER. Any way I can get it, I'll take it.

I have a couple of comments to Mr. Fiechter and Comptroller Ludwig and a question to Chairman Helfer.

Mr. Comptroller, I do appreciate the perspectives you brought to the debate. I think it is very important. I think all of this is just a starting point. There are seven more of these hearings to follow, perhaps others. This is going to be a lengthy debate and I suggest a considerable number of different approaches might be considered before it is finally concluded, but I have full appreciation for your

view that product diversity within a financial market operator is significantly important.

There seems to be a focus, however, at this point on the products themselves and whether they engage in that service or product is inherently bad or adverse to common sense risk-taking, rather than looking at the tail end of the process and saying if business losses occur, which they will occur in any business at any time.

What should be the responsibility of the taxpayer to help that entity remain solvent? Do you or have you looked at the advisability of changes to our deposit insurance coverage in light of expanded powers that might be granted under some new proposal yet to be tendered?

I'll move along because our time is going to be real short here in a minute and you may wish to respond to that to me in writing at a later time.

Mr. Fiechter, with regard to the unified thrift issue and the requirement to diversify what is now in a proven nonrisk activity of certain affiliated transactions between holding companies and thrift members, I would appreciate your giving a little more detail to us about the specific historical activities and the relative degree of risk, point to, with clarity, any failures you think which might have occurred as a result of inadequate safeguards and what risks finally did resolve in the hands of taxpayers as a result of that particular structure.

Chairman Helfer, you point out, page 9 of your written testimony, there are two lessons to be drawn from these experiences, talking about a lot of hard times—first, inadequate diversification of income sources is dangerous for banking organizations, a point with which I agree strongly.

However, in your comments you appear to support only moving perhaps to securities. I am unclear as to whether you think insurance transactions would be appropriate at this point.

Have you reached a policy determination as to whether you think the umbrella might be opened further or should it only be involved with the securities matters at this point?

Ms. HELFER. My statement addresses in particular securities activities because we have actually a lot of experience, more than is generally understood, in that area.

U.S. banks became major underwriters in the Eurobond market outside the United States over the last few years, particularly in the 1970's, in operations that were conducted through subsidiaries of U.S. banks——

Mr. BAKER. I'm sorry to—our clock is running on.

Ms. HELFER. Sure. With respect to insurance, while I haven't studied the issues in detail, I would say there are some types of insurance which I think pose no additional or new risk to the insurance funds such as life insurance underwriting, which is essentially based on actuarially determined risk.

I have some personal reservations about issues associated with property and casualty insurance underwriting which are subject to a much broader range of risks——

Mr. BAKER. Suffice it to say, then——

Ms. HELFER. And I want to study those issues more closely.

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Mr. BAKER. That the umbrella is not clearly defined, it could be modified slightly?

Ms. HELFER. Yes.

Mr. BAKER. But it would be on an issue-by-issue basis?

Ms. HELFER. Yes.

Mr. BAKER. The reason for bringing that point up is that I find it difficult to reconcile that view with the fact that the FDIC has not taken action of recent date to regulate derivatives, which we don't really know the risk that is out there in front of us.

I would rather look to the tail-end of the process and look to what we do to control taxpayer's liability to pay off untoward events rather than prescribe products or services that just inherently can't be offered.

I think that is adverse to our free enterprise system. Let's get the taxpayer out and I will have a proposal for all of the regulators which I hope you will seriously consider as an adjunct to that which is already pending with regard to that issue. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. We will recess for 10 minutes, and Mr. Baker, if you have any additional questions, I'll turn to you then.

[Recess.]

Chairman LEACH. If we could reconvene, and let me turn to Mr. Baker if he has a follow-on question.

Mr. BAKER. Thank you, Mr. Chairman.

I'll be real brief. I really don't have to pursue another question. At the conclusion, I was just tossing an idea over there to which I was going to give an opportunity for Ms. Helfer if she chose to respond any further.

I just wanted to come back and make sure I heard your responses.

Ms. HELFER. Well, I would like to respond to the comment that the FDIC doesn't regulate derivatives——

Mr. BAKER. Let me cast a different net. What I meant by that, because of the press of time, is that certainly you regulate as do all others interested but, what I am suggesting in the derivatives issue is that it's a product that moves dramatically. We can't really regulate it. We can only react to it because it changes daily.

I see the market the same way. We can't regulate it because it changes so dramatically and there is no greater risk implicit with the sale or holding of derivatives for your own account than there is in engaging in other products, and that is my point really, and I didn't mean for it to come across——

Ms. HELFER. All right. Well, I do understand that point and I thank you very much for that clarification because what we do try to do very much is insist that banking institutions have appropriate controls in place that are commensurate with the level of risk that the institution engages in and in the risk that it undertakes.

Those controls are controls that the senior management of a bank must also monitor regularly, and that, Chairman Greenspan was quite eloquent in saying, in the end, it is the combination of adequate supervision on a regular basis and examination. Use of the bank examination authority, together with firewalls which may become, as he said, squishy in times of stress, which my testimony

outlines as well, is what will be appropriate for supervising what may be activities that present new risks, as you point out, and evolving risks over time.

In that sense I certainly would agree with you that the evolution in the financial marketplace goes in directions that none of us can predict. Indeed, we may see even a greater merger of instruments and activities in years going forward, which I think is what your bill is intended to deal with. I commend you for trying to take a look now at those issues which we very much need to understand.

Mr. LUDWIG. Do you want us to respond in writing or otherwise to your other questions?

Mr. BAKER. I would ask the Chair's pleasure?

Chairman LEACH. Please. I think you could respond, yes.

Mr. LUDWIG. You raise the issue of whether or not new activities should be outside the deposit insurance net. I commend Chairman Leach for raising the issue in his bill, and I think you may do so as well in your bill. The wholesale funded depository, where a depository is taking institutional deposits, is an alternative that may address some of the concerns that you have raised and that may indeed be an option.

Mr. FIECHTER. I would like to respond in writing. You asked about specific cases. Thank you.

Chairman LEACH. Let me just make one very quick point and then turn to Mr. Bentsen.

I would also say on the issue of whether you have activities in the holding company versus within the bank, one of the concerns of Congress, particularly the Commerce Committee but also this committee, is the question of functional regulation. There is a historic belief that if you have it in the holding company structure you have a little more pristine approach to functional regulation. That has been an assumption. It may not be 100 percent valid but it is one of the guideposts by which in an inter-committee circumstance out of comity and also for shared concerns that there are reasons to approach it that way.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me first comment on something that Mr. Schumer had brought up, the aspect of potential of, I guess, tying is what it's been called in the past and I can assure you in my days as an investment bank while you didn't go into the room in the bank in its securities portion that both people were there, but I do remember competing against some banks and the chairman of the board, who was making the decision, also had a lot of loan activity with the bank, and there are more than a number of occasions where we lost I think in part due to that, so I think subtly that goes on regardless of what you do.

I think you try and beat that by being more competitive.

I would like to ask a couple of questions, first relating to the Administration's concept of the corporate structure, as you see it, in your bill, and how that relates to—I gather that what you all are saying is that you support some form of a subsidiary structure rather than the Chairman's affiliate structure or even a complete integration of investment banking and commercial banking.

I would like you to comment on that to make sure I understand it properly.

Second of all, earlier this morning Chairman Greenspan testified. You all were here for most of that, I think and he talked about the fact that even though you might have a separation with a subsidiary, for accounting purposes a loss in the subsidiary would run upstream to the parent company and would affect their balance sheet at least for accounting purposes, and I would like to hear your comments on that.

Mr. LUDWIG. First, to your comment about structure, the Secretary tomorrow will lay it out in greater detail. The proposal does not require that new activities be conducted in a subsidiary of a bank, but rather it leaves it up to the institution and the marketplace to determine. In other words, the locus could be a holding company affiliate, as Chairman Leach has proposed in H.R. 18, or a subsidiary of a bank with firewalls and supervisory controls to make sure that there was adequate safety and soundness. Rather than choose the corporate form for the institution, which we don't believe makes a difference from a safety and soundness perspective, we would leave it up to the marketplace.

Second, as to the accounting issue, where a subsidiary gets in trouble, and either the regulator directs the liquidation or it goes into bankruptcy, you would deconsolidate from an accounting perspective, and the loss would be limited to the investment. You could also, if you wanted to, have a RAP accounting convention that would deconsolidate, but I think it is taken care of under current accounting.

Mr. BENTSEN. In terms of the firewalls that you were talking about setting up, I gather then what you are saying is that leave it up to the institutions to decide what structure they want to do within come confines of some rules, but in terms of the firewalls, and I think you all touched on this earlier, would there be any sort of capital requirements for the subsidiary——

Mr. LUDWIG. Yes.

Mr. BENTSEN. I mean that in terms of if Bank A decides to set up an affiliate or investment banking subsidiary, would they have a separate capitalization of that subsidiary?

Mr. LUDWIG. Absolutely. There would be, as I mentioned in my oral statement, 23A and 23B and capital firewalls. This will be laid out in a more detailed fashion by the Secretary of the Treasury.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman LEACH. Thank you. Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman.

Good afternoon. I was going to say good morning—last time I was here.

I understand that you have already to some extent taken positions on some of the bills, both H.R. 18 and the sort of Baker-D'Amato approach, but I wonder if you could outline where you would have problems that could not be resolved through your current regulatory powers extended to a more diversified holding company or entity with the Baker approach, and possibly starting with the Controller, Mr. Ludwig.

Mr. LUDWIG. Let me say in terms of both H.R. 18 and the Baker bill, there are a lot of good things in both bills. Indeed, the Baker bill actually contemplates the sort of structural flexibility which we have been discussing so much here today.

In terms of the firewalls in the Baker bill, they are similar in some respects to those in H.R. 18. I would urge in both cases that the regulators be given flexibility to set firewalls appropriately for the specific kind of activity involved. That is important because otherwise—particularly where you have activities pulled out of the bank, some of which may really not be that risky—you can set up so many firewalls that you lose the synergies.

Under the Baker bill we would have significant regulatory authority, as we would under the proposal of the Chairman.

Mr. LAZIO. Are you satisfied with that?

Mr. LUDWIG. I think that under both structures there would be satisfactory regulatory authority. As I said, I think it is important to have that, and I think it is important to have as much flexibility as possible because this is a dynamic world.

Mr. LAZIO. So you think under either proposal that you would have sufficient regulatory flexibility to protect deposits, deposit insurance more particularly?

Mr. LUDWIG. I think we would have sufficient regulatory tools. I would like to get back to you in writing with respect to whether or not the specific firewalls in the Baker approach have the flexibility for the regulator that I have mentioned several times this morning. Fundamentally, both approaches give the bank regulator the tools that the regulator needs to properly supervise.

Mr. LAZIO. Thank you.

Ms. HELFER. Congressman Lazio, I would like to add, because it hasn't been added for the oral record at least, although it is in my written statement, the FDIC is concerned that there is one area where section 23A has an exemption for transactions between the insured bank and a wholly owned subsidiary.

The First Options case is in fact an example of a situation where the lending from the insured bank to First Options was not governed by section 23A and section 23A was not actually applied by the regulator as a prudential matter. We at the FDIC are concerned that we have seen examples over the last 10 years in some cases that have caused losses to the insurance fund where there have been transactions between the insured bank and a subsidiary that were not governed by the restrictions of sections 23A and 23B so we encourage the committee to take a look at that and see if we can strengthen those particular protections.

Mr. LAZIO. To what extent was that a judgment on the part of the regulator?

Ms. HELFER. Well, actually, the provision, Section 23A of the Federal Reserve Act, specifically excepts transactions between the insured bank and the wholly owned subsidiary, those that are covered loans and the like and other covered transactions.

Generally regulators have applied section 23 in those contexts as a prudential matter to protect the insured bank, but not always, and for that reason we have had concerns that on occasion there have been losses to the insurance fund where those protections have not been adequate.

Mr. LUDWIG. If I might respond specifically to the First Options matter because it was our institution, we did in fact have restrictions in place. In other words, as the Chairman correctly stated, frequently we impose by condition the 23A and 23B limitations. So,

for example, when we recently approved Mellon's acquisition of Dreyfus Securities, we imposed limits by condition.

First Options was a case where our conditions were violated and the transaction was reversed within hours. As soon as we found out about it, we demanded that it be reversed and it was reversed within hours, but it is a case where we did in fact impose conditions by agreement.

Ms. HELFER. Unfortunately, we have examples where such transactions were not reversed in other institutions and there were losses to the insurance fund, which is why I wanted to bring this to the committee's attention.

Mr. LAZIO. Thank you. I know my time has expired.

Mr. BAKER [Presiding]. The gentleman's time has expired.

Mr. LAZIO. Thank you.

Mr. BAKER. Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman. I guess I don't really have a question, but just—and I missed your testimony and the questions before so I don't want you to duplicate it if we can avoid it, but just listening to this, Mr. Baker's bill, which I am a co-sponsor of, I think has some arguable, valid points for its consideration. Mr. Leach's bill is perhaps a little more conservative but also does. The Administration apparently has a separate proposal.

Some of this I guess is new to you, too, for all that matters, in the last few days.

I don't really care about the struggle over who should do the regulatory work but I just care about getting this right. I haven't heard anybody testifying today and I don't think any of your testimony said—I haven't heard anyone say that they are opposed to this reordering of the financial industry or whatever and this is not a very partisan issue, it seems to me, and it goes beyond any particular administration.

I would just hope we would all be able to sit down and really work on this together.

It would help me just to see a comparison of these three or any other measures as to what they all do as to the impact on the different groups and individuals that would be affected by it, just to get a real firm grasp of what we are dealing with.

This is not easy material for Members of Congress who are worried about a regulatory bill on the floor and the welfare reform coming up, whatever the heck it may be. It would be very, very helpful for us to have that information, not in the form of a Banking Committee with 5 minutes of testimony and 5 minutes of questioning but in the form of good production so that we could really see what all this does and be able to reach our own decisions.

I am firmly convinced that we should do something. I know Richard would like me to say I am firmly convinced we should do his bill. I am not totally convinced it is the only way to go, although I think it is a very good start, and I would hope that we would be able to secure that information beyond normal testimony.

I am not even saying it doesn't exist now but as we develop this, that would be very helpful to me. I don't know about the other Members, but it sure as heck would help to develop my thinking because I really want to get this done. I don't want to see it end

up in some sort of a political struggle, so I'd just leave you with that, for whatever it's worth.

Mr. LUDWIG. We would very much like to work with you.

Ms. HELFER. Yes, indeed.

Mr. BAKER. Mr. LoBiondo, do you have a question?

Mr. LOBIONDO. No questions.

Mr. BAKER. Mr. Watts.

Mr. WATTS. No questions.

Mr. BAKER. Well, I've been given the discretionary authority to make this decision. This holding company is now absolved. [Laughter.]

[Whereupon, at 2:27 p.m., the hearing was adjourned.]

H.R. 1062, THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995, GLASS-STEAGALL REFORM, AND RELATED ISSUES (REVISED H.R. 18)

WEDNESDAY, MARCH 1, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to notice, at 10:30 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach [chairman of the committee] presiding.

Present: Chairman Leach, Representatives McCollum, Roukema, Bereuter, Roth, Baker of Louisiana, Lazio, Bachus, Castle, Royce, Lucas, Ehrlich, Chrysler, Cremeans, Fox, Heineman, LoBiondo, Watts, Kelly, LaFalce, Vento, Schumer, Frank, Kanjorski, Kennedy, Flake, Orton, Maloney, Roybal-Allard, Barrett of Wisconsin, Velazquez, Wynn and Bentsen.

Chairman LEACH. The committee will come to order. Let me apologize. The party had a caucus on Mexico this morning that went a little bit longer than expected. Let me make one announcement for the committee in that regard.

It is the intent of the majority leadership to bring up the Kaptur resolution on Mexico, that was reported out of this committee, late this afternoon or early this evening, so it is expected to be on the floor this evening.

There will be an hour debate which is controlled by myself as Chairman of the committee. I will give half the time to the minority party, presumably to Mr. LaFalce, but that will be worked out at a later point.

Finally, with regard to Mexico, as we greet our distinguished Secretary of the Treasury to discuss Glass-Steagall, let me stress as strongly as I can that there are clear differences in judgment of many Members of Congress on this issue, and these are fair and reasonable and philosophical differentiations, but speaking from this Member's perspective on the issue of ethics, I have thorough confidence in the Secretary of the Treasury, and I would stress to everybody in this room that the Secretary came into public service and thereby limited his capacity to earn money, not the reverse.

One may or may not agree or disagree with any Treasury policy, but that is a very different issue than agreeing or disagreeing with the ethics of the individuals that are conducting the stewardship of our economic policy, and this Member has thorough and complete confidence on that score.

Mr. Secretary, we welcome you as well as Mr. Newman, and if you have an opening statement, pleased proceed.

Mr. RUBIN. Mr. Chairman, let me start by thanking you for your remarks. Chairman Leach——

Chairman LEACH. Excuse me. I don't mean to cut you off. Others might have opening statements. I didn't inquire in advance, and I apologize. Any on our side?

[No response.]

Chairman LEACH. On your side, John?

Mr. LAFALCE. I think because we are starting so late it would probably be best if we just put them in the record.

Chairman LEACH. Let me turn quickly to Ms. Maloney. Your hand is raised.

Mrs. MALONEY. I just want to thank the Chairman for his comments and state that long before Mr. Rubin joined government, which was well over 2 years ago, he took many steps to be independent. He has put all of his assets in a blind trust. I have known him for 20 years. He has served our city of New York in various public capacities, in addition to his work on Wall Street, with great distinction and has a reputation beyond refute, and I am deeply troubled by the troubling comments made by one of our colleagues on this committee that had absolutely no merit, was waving a flag, insinuating, and I am deeply offended by it.

I just wanted to put that on the record, and to thank the Chairman. I agree, we can disagree on the merits, but let's not turn this into a witch hunt or a McCarthyite attack on another person.

Likewise, I would for the record like—and I had no intention of making an opening statement, but I did want to make a few comments on yesterday's hearing.

I want to comment on some of the things that Federal Reserve Chairman Alan Greenspan said. Knowing of Chairman Greenspan's support for modernization of our banking laws, I fully expected his testimony to provide assurances that these proposed reforms will not affect the safety and soundness of the nation's deposit insurance system.

However, a number of Chairman Greenspan's statements actually heightened my concern over the impact of these reforms on deposit insurance.

First and foremost, I am very troubled over the Fed Chairman's assertion that, and I quote, "firewalls melt in a crisis," and by his inability or unwillingness to specifically suggest what structures could be put in place to prevent such a meltdown.

Second, I found Chairman Greenspan's answer to my question about conflicts of interest within these proposed diversified companies to be extremely troubling, and I was likewise troubled by his assertion that there is no way to control the so-called "rogue traders" that happened in Kidder Peabody, Salomon Brothers, and most recently in Barings.

But if we put banks with insured deposits at risk to the actions of these rogue traders, aren't we then conceding that some banks will fail because of these traders and the Fed's apparent position that it cannot protect the bank against them?

I share the concern of most members of this committee that our financial services laws must be updated, but from what I heard

yesterday, the risks of the proposed reforms may be far higher than we had anticipated.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mrs. Maloney.

Secretary Rubin.

STATEMENT OF HON. ROBERT RUBIN, SECRETARY, DEPARTMENT OF THE TREASURY; ACCOMPANIED BY FRANK NEWMAN, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. RUBIN. I think, Mrs. Maloney, or at least I hope that my testimony and our comments will be responsive to some of the questions you have raised, which we also think are exceedingly important questions.

Mr. Leach, Mr. Gonzalez, members of the committee, I am very pleased to be here today with Deputy Secretary Frank Newman to discuss the Administration's views on repealing the Glass-Steagall Act and modernizing our financial system, all in the context of an absolute commitment to maintaining safety and soundness.

Both of us have had long hands-on experience in the matters before this committee today. We have both worked diligently on the proposals under consideration, and both of us are committed to a productive dialogue with Congress on financial modernization.

While I shall proceed with the opening statement, it is our hope that the Members of the committee will look to both of us for comments in the subsequent discussion.

Mr. Chairman, there has been a great deal of, in our view at least, common ground on the big issues that have developed over the course of the last few months, and your leadership, obviously, has played a major role in that.

In our view, that agreement on the big issues is the forest, and while there are differences on some of the specifics, and one of them, obviously, is the right to use the subsidiary for the non-bank affiliates, and while these specifics are important and need to be resolved, nevertheless, in our view, these are trees.

So as we go through both my testimony and our discussion, we would like to suggest that we always keep in mind the context, which is the agreement on what are really the big issues about combining these industries.

As I say, I think you have played a very major role in leadership in forging that agreement, while at the same time we discuss the specifics on which there may be disagreements.

The proposals that you have introduced, in our view, are extremely well-framed, and will serve us well in discussions leading to a balanced and constructive legislative resolution.

This committee has provided strong bipartisan leadership in the past Congress for important banking legislation. I'm referring specifically to interstate banking. We believe that by continuing this bipartisan manner, we have the opportunity to continue the enactment of historic reforms of our financial system.

The case for financial modernization has been made repeatedly over recent years. Let me just briefly go back to it, if I may.

Fundamentally, the segmentation of financial markets and institutions envisioned in current law does not correspond to current

circumstances. Commercial banks compete vigorously with securities firms, mutual funds and insurance companies for the funds of savers, and banks no longer rely on traditional loans as their primary source of growth and profitability.

Banks have responded by offering new products and services intended to generate fee income, and by expanding into markets related to their basic business such as insurance, securities, mutual funds and trading.

Like banks, other providers of financial services have diversified over the years, in many cases by introducing bank-like products. For example, securities firms offer cash management accounts as substitutes for commercial bank deposits, and securities firms, in some cases, issue credit cards. Securities firms are active in making commercial loans, either directly or as loan syndicators. Finally, securities firms compete with banks through commercial paper, private placements and securitized assets.

Like securities activities, insurance activities bear important similarities to banking. Insurance companies seek to attract savings, like banks. Insurance companies intermediate funds received into loans, like banks. Insurance companies are involved in many of the same functions as banks and securities firms in support of the insurance company activities, for example, trading and various kinds of investment activities.

Because of these similarities, there is, in our judgment, and obviously in your judgment from the legislation that you've introduced, a strong case for permitting affiliations between banking and securities firms, offering opportunities for efficiencies and better service, and we would extend that to insurance companies.

For these reasons we believe that current restrictions on affiliations between banks and insurance companies and securities companies are outdated and overly restrictive. At the same time, we are exceedingly mindful of the varying degrees of risk that accompany different types of insurance and securities activities.

To focus for the moment on insurance, underwriting life insurance presents less risk than underwriting certain lines of property and casualty insurance. The structural framework for financial modernization should provide for ways to deal with these facts and distinctions.

The U.S. financial system is the most restrictive of the developed economies with respect to structure and affiliations of financial institutions. Where these restraints have become outmoded by changing conditions, in our view, those constraints should be lifted. A more modern legal framework can make U.S. banks, securities firms, insurance companies and other financial firms more efficient at home and more competitive in the international marketplace.

Having said that, let me repeat once again: it is absolutely essential that the financial system maintain safety and soundness. In our view, properly structured product diversification should increase—not decrease—safety and soundness just as we believe the interstate banking legislation that you passed last year increased safety and soundness through geographical diversification.

Let me now go into our views on the structure of financial modernization. The Administration's approach to financial system reform has six key objectives. First, as I said a moment ago, promot-

ing efficiency and competition, and thereby providing better service for users by eliminating unwarranted restrictions on financial service providers.

Second, maintaining, and in our view, enhancing safety and soundness of FDIC-insured depository institutions and the Federal deposit insurance funds. We would be opposed to anything that we felt diminished safety and soundness.

Third, encouraging market discipline by avoiding extension of the Federal safety net.

Fourth, providing effective oversight of the affiliations and the activities in question.

Fifth, providing a meaningful two-way street by which securities firms can affiliate with banks or banks with securities firms.

And, sixth, making U.S. financial service providers stronger at home so they will be better able to compete abroad.

As a general matter, we would permit an FDIC-insured depository institution to affiliate with a securities firm, insurance company or other financial company.

We would likewise permit such a non-bank financial services company to affiliate with an insured depository institution. In other words, it can go both ways. This could be done by allowing the affiliated company to be a subsidiary of the insured depository institution, or the institution's parent company.

In other words, the structure could either be through a holding company, or the non-bank financial services company could be a subsidiary of the bank. The choice of corporate structure would be a private business decision.

In our view—and we think this is a very important subject for future discussion, both in this hearing and subsequently—there is no inherent difference with respect to safety and soundness, between a holding company structure and a subsidiary structure.

The whole question is what are the safeguards, what are the firewalls, and how are the activities between the two institutions conducted.

If that is correct, and that is our view—but, as I said, that is something which we presumably will have an opportunity to discuss today, and we look forward to discussing in days subsequent to this hearing—then we believe the private sector should be able to decide for itself how to structure its business.

Having mentioned firewalls, let me immediately say again, as I said a few moments ago, that we believe in strong firewalls, and we believe in legislated firewalls.

Under our approach, insured depository institutions could affiliate with firms that underwrite securities or insurance only if regulators make several findings.

First, that the institutions are well-capitalized and well-managed. Second, that the institutions and their affiliates have internal controls adequate to manage financial and operational risk. And, third, that the affiliation would be unlikely to impair the institutions' safety and soundness.

We believe it is absolutely critical that insured depository institutions' affiliates not become a source of weakness to the insured depository institution. It is for that reason that we have the requisites for affiliation that I just mentioned. It is also for that rea-

son that we would maintain regulators' authority to impose consolidated capital standards on bank holding companies.

Consolidated capital standards can serve as a measure of the health of the overall organization and thus reduce the chances that the affiliates' weaknesses, if such should develop, would pose unacceptable risks to insured depository institutions. But applying consolidated capital standards to highly diversified organizations when the insured depository institution is a relatively small percentage of the entire institution, may create problems. Accordingly, our approach provides for the establishment of a forum for regulators to determine the circumstances under which consolidated capital requirements should apply when you have holding companies that have less than half of their assets in insured depository institutions.

In addition, we would maintain the authority of insured depository institutions' primary Federal regulators to verify compliance with restrictions on the institutions' transactions with affiliates, and we would require Federal regulators to coordinate the institutions' examinations to prevent such abuses as shell games as well as to minimize overlap. This would complement existing law requiring regulators to coordinate examinations so as to reduce regulatory burden.

We believe that firewalls, and I am repeating something I said a few moments ago, and particularly restrictions on transactions between an insured depository institution and its affiliates, should be strong enough to provide necessary protection to the insured depository institution and should be legislated. We are confident that, together with Congress, we can construct such firewalls without negating the synergies which would result from allowing institutions to affiliate in the first place and which are the overall purpose or objective of this entire undertaking.

To achieve true competitive equality and opportunities for efficiency and competition, we would permit companies engaged in financial activities to affiliate with insured depository institutions, just as insured depository institutions are permitted to affiliate with such companies. That is a two-way street. We also would allow an affiliate of an insured depository institution to hold a diversified portfolio of investments in nonfinancial firms made in the course of the affiliate's merchant banking or venture capital activities. That reflects the reality of modern brokerage and investment banking firms, almost all of which have portfolios of these kinds of investments. But we would limit such investments in the aggregate to an appropriate level, and our suggestion is 5 percent of consolidated assets, though that is obviously a subject that we are totally open to discussion on.

A brief comment, if I may, on functional regulation. Functional regulation, as you know, refers to a regulatory process in which a given financial activity is regulated by the same regulator regardless of who conducts the activity. The purpose of functional regulation is to bring greater effectiveness and efficiency to the regulatory process. To advance this approach, we would limit banks' current exemption from SEC broker/dealer registration and eliminate banks' exemption from investment adviser registration. We also would facilitate appropriate delegation by the functional regulator

to the lead regulator for the entity in the interest of simplicity and regulatory economy.

We would establish a seven-member National Council on Financial Services, consisting of the Secretary of the Treasury, the chairman of the Federal Reserve Board, the chairmen of FDIC, the SEC and the CFTC, the Comptroller of the Currency and the Director of the Office of Thrift Supervision. The Council would be an interagency policy forum, not a hands-on regulator or bureaucracy. The Council would be authorized to define what activities are financial—the concept or the definition of what is a financial activity is very likely to change over time just as it has over the last 10 or 15 years in a very rapidly changing world that we live in—and to deal with other appropriate matters.

Finally, we believe it to be logical and sound to permit well-capitalized and well-managed national banks to underwrite and deal directly in municipal revenue bonds. We do not support removing the current prohibitions against combining banking and Congress—well, banking and Congress as well, but I really mean banking and commerce. [Laughter.]

In our judgment, the removal of such restrictions creates the possibility of abuses through bank transactions with companies that purchase from or supply to affiliated industrial companies to a far greater degree than would be the case for affiliations between banks and financial services companies. On the other side of the ledger, we do not see any particular synergies or benefits from allowing such combinations.

To reap the full benefits of financial modernization, financial modernization legislation in our judgment should provide national treatment in the United States for foreign financial institutions with respect to the benefits of affiliation. Failure to provide national treatment, in our judgment, sends the wrong signal and cuts against our continuing efforts to open foreign financial markets to U.S. financial services providers. It would also discourage many foreign financial institutions from committing their capital and resources to our markets.

Let me close, if I may, with a few comments on H.R. 18. As I indicated at the beginning of my comments, we believe that H.R. 18 contributes enormously toward the ultimate objective of getting legislation that modernizes this nation's financial services industry. The Glass-Steagall provisions represent significant financial reform, and the bill promotes financial system safety and soundness and protects consumers by emphasizing strong capital, firewalls and consumer disclosures. It also advances functional regulation, which we believe is appropriate.

However, H.R. 18 is based exclusively on the holding company approach to expanding bank activities. As I said in my opening comments, we believe that the agreements between our approach and H.R. 18 constitute the forest. What I am now referring to is a tree, but it is an important tree and it is one that we need to sort out over time.

We believe that because, in our judgment, the subsidiary and the holding company structures are equivalent in terms of safety and soundness, the private sector should be allowed to choose which structure they would like to have. We also believe the bill should

be broadened to permit banks and insurance companies to affiliate with proper standards and safeguards, recognizing that the property and casualty issue is one that we need to work out.

The proposed legislation, H.R. 18, includes a number of explicit interaffiliate transaction restrictions designed to insulate the bank from the securities affiliate. We share the commitment that those prohibitions represent, and we would like to work with the Congress in developing firewalls that are strong, that are legislated and that protect safety and soundness.

Let me conclude, Mr. Chairman, as I think I started, by saying that as we move forward, we think there are great opportunities to make a contribution to the functioning of our economy through the modernization of the financial services industry, but it must, in our judgment, and we believe your bill reflects the same view, all be done in the context of doing absolutely nothing that undermines safety and soundness and, in our judgment, in fact should wind up enhancing safety and soundness.

We also believe, as I said a few moments ago, that while there are differences, those are differences that we can work on together, and those differences should not prevent us, all of us, from together reaching a conclusion upon which we can agree, based on the far more important and larger issues on which we do agree, and ultimately result in legislation that you can pass and the President can sign.

Let me also very briefly comment on one other matter. I welcome the opportunity to participate in hearings that I gather you plan to hold, Mr. Chairman, later this month on the Savings Association Insurance Fund. The Fund has less than $2 billion in reserves to insure over $700 billion in insured deposits. We believe that a thoughtful public review of the Fund's prospects is very appropriate and we look forward to that hearing.

Mr. Chairman, again, we congratulate you, Mr. Baker and the Members of the committee for moving expeditiously to deal with financial modernization. We believe, Mr. Chairman, that you have provided enormous leadership in this direction. It is our view that an interactive, bipartisan effort can yield significant results in relatively short order. We look forward to working with you in the coming months to achieve our common goals.

At this point, we would be delighted to respond to any questions the committee may have.

[The prepared statement of Hon. Robert Rubin can be found in the appendix.]

Chairman LEACH. Mr. Newman, did you want to make an opening statement?

Mr. NEWMAN. No, thank you, Mr. Chairman.

Chairman LEACH. Just a minor correction. Mrs. Roukema's subcommittee will hold the principal hearings on BIF and SAIF. She has indicated a terrific desire to work with the Administration. I do not want to——

Mrs. ROUKEMA. Yes. I did not hear the reference. I am sorry. Thank you, Mr. Chairman. I appreciate that.

Mr. RUBIN. In that event, we enormously welcome working with you on what we think is an issue that is very much worth having a public discussion of.

Mrs. ROUKEMA. And that is already scheduled and we will share the schedule with you.

Mr. RUBIN. Good.

Chairman LEACH. Let me just say, despite the press, there is basically broad agreement on the Administration approach with H.R. 18. There are going to be a number of nuances of disagreement and let me just say, as we move to markup, I am confident the committee is going to work with all elements of the executive branch in terms of giving fair review to everyone's perspective and we will certainly wish to do that.

Let me just say there are two philosophical issues, one of which the Administration has indicated agreement with H.R. 18, one of which they have not, they have indicated disagreement. Let me first turn to the one of agreement which relates to whether or not banking and commerce ought to be commingled and if I could I would like to turn to Mr. Newman as a former banker and just ask his perspective on the banking and commerce issue.

Mr. Newman.

Mr. NEWMAN. Thank you, Mr. Chairman. I do think it is an issue that is complex, and everything is a matter of degree. It is not that there is a single bright line that one can paint between one business or another business. Some judgment is called for.

First of all, in looking at the context, commercial ownership of banks is really not common in other countries. Actually, in none of the G–7 countries, as I think Chairman Greenspan mentioned yesterday, are any of the major—the largest—banks actually owned by industrial companies. It is a little bit more common to have industrial investments by banks in some countries, but it is really only in Germany that it is particularly common.

One has to question why an industrial firm would want to own a bank. If it were simply for investment, then the industrial firm could invest in a portfolio of banks, and that is already allowed today. One needs to question the synergies, in a sort of spectrum. One could say, well, there might be some synergies, but the farther you get away from financial services, the less and less easy it is to see any meaningful synergies between a widget company and a bank.

There are potential abuses and there are abuses that need a lot of study. There are problems that range from the possibility of money laundering, for example, the possibility that a company might purchase or create a bank solely for the purpose of laundering money.

There is not only the question of potentially direct abuses of loans from the bank's subsidiary to the parent industrial firm itself. But it is even more complex than that because of the commercial relationships. For example, suppose you had the Ajax Widget Company, and its main business was manufacturing and selling widgets and that is where its heart was. It wanted to sell a lot of widgets to the Acme Distribution Company but that distribution company happened to have financial difficulties.

So you can picture a situation in which the management of the widget company says, not to worry, we own a nice bank that I am sure would be very happy to help you out with your financial difficulties so you will be able to purchase widgets from us. It is even

possible that this could take place with suppliers, where a supplier who was providing an important component for the widget company, or maybe could provide lower cost components if they had good financing from a bank, might be subject to some special terms or to the bank lending when it otherwise would not have felt that supplier to be a good credit.

I've actually even been told about some circumstances in other countries where industrial espionage, where essentially the industrial company was trying to get access to confidential loan documentation of competitors in order to literally use it for industrial espionage. All of this could be dealt with over time, but it is really not something we are well prepared to deal with. It is hard to see, given the lack of identifiable benefits, it would take a whole new regulatory structure in order to prevent this kind of abuse, and it's something we are not ready for, at least at this point in time.

Chairman LEACH. I appreciate that. Let me just say the point where there is disagreement relates to whether or not to put new activities in a holding company versus an internal bank subsidiary structure, and I'm sure others will deal with that, particularly Mr. Schumer.

I would only stress that I spoke last night to a former German central banker, Otto von Lambsdorf, who is leading the charge to change German law, which is very different than our own law and German law has allowed this integration, for example Deutsche Bank owning Daimler Benz or large elements of it, and it has now become a national scandal in Germany and the German people are demanding change.

One of the points he made that I had never heard before, which was a very interesting point, is that banks always get antsy about the lack of dividends from companies that they own, and so they press for more loans, sometimes not just at advantageous interest rates to the company but to the bank is another way of getting revenue and seeking a loan environment instead of forcing the company to go to capital markets, which is an arrangement that is a theoretical problem I'd never considered, but when you do get internexes you do have difficulties.

My time has expired. I would like to turn to Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman.

Well, I think I will enter that foray you suggested you didn't quite get into with regard to the subsidiaries being owned by the bank.

I have a question that really relates to theoretical, which I think all of this is right now. I'm looking out in a situation where a holding company exists and you have got a bank over here and you have got a securities subsidiary over here, so you have a very simplistic thing.

If the securities subsidiary gets in trouble in any way, goes bankrupt or otherwise, and there is any problem, if in essence the parent company is going to be held responsible and the corporate veil might be pierced for control, lawsuits could exist, that's a common thing in law practice, the holding company is the one that's going to take the hit, so to speak. The bank still is over here. It's a separate subsidiary and under traditional law at least would not necessarily be involved in this. In fact, we wouldn't expect it to be.

On the other hand, if you have got the bank owning the securities subsidiary, the securities subsidiary goes bankrupt or has other problems, I can see creditors potentially being able to get courts convinced that the bank board of directors actually has such control over the securities subsidiary that they have the right to the claim, all the way back through the bank, and it would seem to me that would put the stress on the bank itself directly in that situation as opposed to the holding company, forget the hanky-panky. Just plain ordinary everyday corporate law.

What response do you have to that, Mr. Rubin? I know you must have thought about this.

Mr. RUBIN. It occurred to us.

We have spent a lot of time analyzing the very issues you raise, and I think it's an exceedingly important issue, this question of the corporate veil.

It is our judgment that the corporate veil issue is the same in either instance, but I really think that this is something we need to sit down with whomever it's appropriate to sit down with and really go through the analysis of it.

If you have appropriate procedures and you adhere to the procedures, then the subsidiary of the bank, the securities firm, if it goes bad, ought not to infect the bank. Conversely, if you don't adhere to the proper procedures, then you do run the risk of the corporate veil being pierced. On the other hand, in the holding company structure, if as is generally the case or very frequently the case, I think probably generally the case, you have all sorts of activities going on, well, you might have all sorts of activities going on between the holding company and the bank and the securities affiliate, so that it provides grounds for piercing the corporate veil. Then you run the same risk there of piercing the corporate veil.

In other words, it's our judgment that the difference isn't in the structure but rather it is in setting up the appropriate safeguards in the first place and then adhering to those safeguards with respect to your corporate practices.

Mr. MCCOLLUM. Well, I guess my common sense type of thing on this, although I have a law hat as well, the common sense one says that you have got an intermediary, so to speak, there with the holding company structure that normally would make it more difficult for the legal forces that be to get all the way over to the bank that's sort of going up and down.

Mr. RUBIN. But I think it depends, if I may say so, I think that sounds right in the first instance, but I think it depends, once you get to the holding company, on what the holding company's relations with the bank are. So once again I think it's a question of has the bank conducted its affairs properly with the holding company so that it has protected itself from being able to reach back from the holding company to the bank.

I guess we would argue that, similarly, if the subsidiary and the bank have handled themselves properly, they should be equally safe and in a sense you face exactly the same problem. The bank is a subsidiary of the holding company where you have——

Mr. MCCOLLUM. Anyway, I think we are going to explore that more. I'm not set in my mind.

One last question in the same area before my clock runs out. How much capital would you require for a bank in order to have a securities holding company? You mentioned something earlier about 5 percent of assets but I don't think that was for that purpose.

Mr. RUBIN. No, that was the question of the venture capital and merchant banking.

Mr. MCCOLLUM. What would you require? How much capital? You said you would require a relatively high minimum capital standard.

Mr. RUBIN. Let me give you a response and see if Mr. Newman agrees, because we haven't thought about a dollar amount. It seems to me it depends on what it is they are trying to acquire.

If you are acquiring a very small securities affiliate that involves very little activity and very little capital risk, then it seems to me your capital requirements would be a lot smaller than if you were trying to acquire one of the national giants.

Mr. NEWMAN. I would certainly agree with that fundamental logic. The standard that we were suggesting applying is well-capitalized, a statutory definition of well-capitalized which is in the law as substantially above that which would normally be required.

Mr. MCCOLLUM. No, I understand that definition. That's just what I wanted to find out, what you were really looking at. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you. Before turning to Mr. Vento, let me say the Chair procedurally has erred in turning to our side first and so I will recognize two Democrats in order, beginning with Mr. Vento.

Mr. VENTO. Thank you. Thank you, Mr. Chairman. We appreciate it.

On the last question, you want to reset the lights so I get my 5 minutes, Mr. Chairman, thank you, Mr. Chairman.

I just think I appreciate the Chairman's statement earlier I think that the nature I guess of public service in 1995 has changed and we regret that. We think the screening process and other things that are gone through and I asked plenty tough questions myself, as you will painfully recall, Mr. Rubin.

The issue I guess here in terms of capitalization is very interesting, Mr. Newman, because obviously some of our largest banks, at least as has been portrayed before this committee, are so large that the amount of capital that they have has sometimes been suggested as it could actually be smaller because the corpus of that amount is go great compared to the types of risk, so this symmetry in terms of saying just because you are big you are going to have more capital is not necessarily what has been portrayed in terms of arguments before the committee and I take it Mr. Newman and Mr. Rubin understand that.

My question really goes to that capital and to the various sizes of entities. You know, what's portrayed here is that if we, for instance, open this up to affiliates in terms of insurance and open it up to affiliates in terms of investment banking, just those two functions, that very likely it's going to be a greater bringing together, that the banks in essence will be running, will be purchasing those.

There will be subsidiaries. There will be holding companies whatever the governance form is.

My question is does that cause some concerns in terms of concentration? I think that obviously one of the greatest levels of autonomy and independence and separation is obviously in the structure that we have, but in the sense when you bring it under, I mean, for instance, an investment bank is looking at a different profit structure, compensation structure, a different culture, and when you bring this all under the same entity either as a subsidiary or as a holding company and we have various degrees of that that occur already today, does that, sort of drawing that together, change the nature of the way we respond in terms of the marketplace today?

Does that in essence freeze the configuration of how we, for instance, raise capital, how we actually finance projects? This is the concern. It's philosophic but it also I think is something that is predictable. I think after all we have some examples of where they have changed laws in recent instances and investment banks have pretty much been picked up by the commercial banks, and I think the same might be true with insurance companies, given the various—where the dollars lie, where the capital lies in terms of these various entities.

Mr. Rubin.

Mr. RUBIN. Is the question basically are we going to have a change in culture as a result of——

Mr. VENTO. Well, are we going to have a concentration and change in culture and does that change the way that these interface with the marketplace is basically the question, yes.

Mr. RUBIN. It is an interesting question. I guess my view would be two-fold.

One is if you think about what has happened in the big money center banks that have become in large measure quasi investment banks over the last 10 years, and Frank Newman can speak to this better than I since he was in one of them—in fact helped run one of them, one of the observations I would have from the outside, having competed with them, is that they all had to deal with precisely the issues that you have just described, that is to say they had to develop a culture that was suited to a business that was somewhat different than the one they were in.

It seems to me that quite a number of them have successfully made that transition and have managed to amalgamate, if you will, both cultures in one institution, so I think that that cultural combination—the challenge of accomplishing that cultural combination and even these enormous differences in compensation which are part of it—has already in large measure been met by——

Mr. VENTO. Those are examples, you're saying.

Mr. RUBIN. By the banks, yes.

On the question of concentration, the financial services industry today is really and truly a global industry. I think if you look at it that way, the numbers of participants are so large that I don't think that anything we are doing here is going to create a level of concentration that should be of concern to us in that respect.

Mr. VENTO. Well, I appreciate that and I would like to give you more time to answer in writing, Mr. Newman.

The other question, Mr. Chairman, that is addressed here is that much of this of course has gone on on a marketplace basis. Obviously I think the European experience in terms of American banks can be helpful in terms of illustrating this and I think this is really where we get the pattern of what Citibank or other large banks, as you said, have really turned into, a different structure.

But I would point out that what we are doing here, of course, and I think key to whether it's the Leach or the Baker approach, is we are putting a greater degree of governance, a greater degree of regulation into the mix of what this format and how they will work together, how they come together to meld together to actually accomplish that, and that is the real question here, because there has been a greater degree of autonomy under the regulatory system for investment banks or for insurance that's had a certain amount of regulation but now we're all of a sudden getting in the mix.

Whether it is functional, Mr. Chairman, or whether it is based on how they are chartered, I think we still have to admit that in the prospect here in terms of capital standards and other matters we are going to have a greater degree of regulation and that's a real challenge in terms of whether or not that will thwart the ability to be as responsive and market oriented as is necessary.

Chairman LEACH. Thank you, Mr. Vento. Mr. Schumer.

Mr. SCHUMER. Yes, I think Mr. Vento's question, to me, is on the money.

I am worried under this system, under any of these systems that the greatest asset America has had financially, and what has allowed us to dominate the world, which is not capital and not regulation because we are outdone by other countries, but is entrepreneurialism, and my great worry about your plan, Mr. Secretary, and about all of these plans is that once you have a large, if you will, corporate structure and particularly when you introduce the element of insured deposits, which entails greater regulation that that entrepreneurialism gets diminished or snuffed out.

The Chairman wisely mentioned the Germans come here and say—I have heard German banker after German banker say we made a mistake because we are not as venturous as you—yes, we have Deutsche Bank and it owns everything and it is big and it lumbers around, but it doesn't have the nimbleness that particularly the non-insured institutions have.

So I would first in general—I am just going to ask one long question and let you respond to that, your fears about that, what you thought about that when you came up with your proposal.

The second issue is related, unfortunately it's not enough in the debate, is insured deposits. The insured deposits requires regulation, more regulation, and the two banks that have adopted, that you mentioned, Morgan and Bankers Trust, they want to get out of being insured banks altogether, I know, and Mr. Leach has put something in the proposal that would allow them to, which was very close to what I was pushing when we were in the majority, which is wholesale bank.

I don't think the mix of cultures has worked very well in other banking institutions. In the last decade we have gone from crisis after crisis, in my judgment all because we have too many insured

deposits chasing too few low risk opportunities, and it is true, the banks are right, that they are pushed by everyone else—everyone can join in their low risk game but they can't join in everybody else's higher risk game.

But I don't know if the answer necessarily is to break down the walls, and so my other question, aside from the conundrum of entrepreneurialism and insured deposits, is do you believe—well, it's related.

You have a subsidiary of a bank, it seems to me, to highlight those dangers, whereas if you have an affiliate of a holding company there are still some of those problems but they are less so.

Finally, I would ask you a specific question. Do you think it would be appropriate when an institution—I asked this to Mr. Ludwig yesterday—and I would like you to clarify if your views and the Comptroller's views are the same because he was sort of "let the regulators do it all, leave it to us, we know everything" and when you sat on this committee for the last decade you don't have that much faith in the regulators, but basically I asked him in this specific example if an institution, a financial institution were making a pitch to underwrite some corporate securities, would it be appropriate for the loan officer to sit in on the meeting, the one who is making loans to that institution all along, and certainly it would even be highlighted if it were a subsidiary rather than affiliate because his boss would be sitting in on the meeting.

OK, a lot of questions, but I respect your judgment so I wanted to ask a lot of them and get you to answer them and expand my time a little bit.

Mr. RUBIN. You've been involved in the subject too long. Let me see if I can run down these real quick.

On the question of entrepreneurialism, I think there's no question the American financial services industry is the leading financial services sector in the world, and it is because of entrepreneurialism.

On the other hand, I think it is equally true that in the world of the last 5 years, 10 years—certainly the last 5 years, to be truly effective, (a) you have got to have enormous capital, and (b) you have to have global presence. The consequence, I think, is all of these institutions are finding they now have to maintain entrepreneurialism while at the same time have much larger organizations than they ever dreamt of having because they need the capital and the global presence.

In that context, with respect to the insured depository institutions it seems to me that whether you use the holding company structure or the subsidiary structure the answer is the same. What you have is functional regulation of the securities firm, which is the regulation they have today, and then the insured depository institution has the regulator it has today or some other regulator if it chooses to, but in any event has a bank regulator, and the bank regulator really only looks to the other activities with respect to ways in which it might affect the bank. So I don't think you are creating a meaningful additional amount of regulation for the non-bank activities. I don't think that should impede the entrepreneurialism.

On the question of banks having to—or the thrust that they have had to go into these riskier activities, any of these proposals should take that pressure off them because now, instead of having to do it in the entity that has the insured deposits, they can do it in a separate entity and thereby not expose the insured deposits to the risks that, I agree with you, may be greater, in fact probably are greater in the non-insured entity, so I think in a way it takes the pressure off the banks to do that in the entity that would expose the taxpayer dollars.

The mix of cultures, that's a different issue. We can just discuss that at our convenience, I guess.

Subsidiary or affiliates, well, I'll go back, if I may, to the statement I made in my opening comment and I made to Mr. McCollum, I guess. I think one of the very important issues that we need to resolve, the details that separate our proposal from H.R. 18 is, is or is there not a safety and soundness difference in the subsidiary form versus the holding company form. We think not, but that is something we really need to discuss, and it is a very serious issue that we would take seriously.

On the question that you asked Mr. Ludwig, speaking for myself I have enormous confidence in Mr. Ludwig. Having said that, we think a lot of this does need to be dealt with in a legislative way. For example, firewalls.

But I think a very interesting question is in order. To get the synergies that we all believe are the purpose of this whole thing, what restrictions if any should exist on common functioning, which is the question you raised, common functioning of employees and officers of the institutions?

Certainly it is our view at this stage of the discussion that we would be very much against tying. Tying is a violation both of the Bank Holding Company Act and of the antitrust laws, so let's stipulate that.

But once you get past that stipulation, our view would be that in order to get the benefit of the synergies, employees should be allowed to cross function, if you will, and that is a subject you may have a different view of.

Mr. SCHUMER. Those step to an unstated tie-in.

Mr. RUBIN. I think that is another subject worthy of further discussion.

Chairman LEACH. Thank you. Mrs. Roukema.

Mrs. ROUKEMA. Thank you. Mr. Secretary, as so often happens, Mr. Schumer has anticipated at least part of my question, but I am going to follow through and ask it in my own way.

There are two related questions here or maybe more than two.

If the subsidiary of a bank goes under—by the way, let me preface my questions by saying you have given of course the same pledge of allegiance and rhetoric to firewalls and safety and soundness as everybody does, so I am trying to get to more specificity beyond the rhetoric here.

If a subsidiary of a bank goes under, the capital of the bank is cted, is it not, and if so, as I believe it is, it's not necessarily t same with the holding company structure, or do you disagree w that?

r. RUBIN. I would tend to disagree with that.

Mrs. ROUKEMA. Before you answer that, please, because the related question is concerning the firewalls, which we have talked about, you have talked about at length, but you haven't defined them.

You have suggested a combination of rules and directives to the agencies regarding firewalls but my question is do you know what types of restrictions you would mandate by statute and which would be in the forms of directives to the agencies?

Would there be a difference depending on whether the activities were in the subsidiary of the bank or a bank affiliate? Now that is related again going back to the first question.

Mr. RUBIN. Let me take a first shot at it, if I may——

Mrs. ROUKEMA. Please.

Mr. RUBIN. And then turn it over to Mr. Newman.

In our proposal the bank's investment in the non-bank affiliate could not count as part of the capital of the bank, so if the non-bank affiliate gets absolutely wiped out, it would not affect the capital position of the parent bank.

Mrs. ROUKEMA. There seems to be a question about that.

Mr. RUBIN. Well, that's again another matter we should discuss as we go forward, but that at least is the way our proposal is structured. Then it gets you back immediately, as you correctly say, to the firewall question because, if what I said is correct, then the bankruptcy that happens, the bankruptcy of the non-bank affiliate, would not affect the capital unless you can pierce the corporate veil. That takes you to the firewalls, and with that I will turn it over to Mr. Newman.

Mr. NEWMAN. Thank you, Mr. Secretary.

Mrs. Roukema, the question that the Secretary just addressed about the capital of the bank is an important one. As I said, our concept is similar to what is done with a section 20 subsidiary right now. It is that the required capital for the main bank would not include the capital that was required to operate the securities subsidiary, so even if a securities subsidiary ran into a dramatic problem, it would affect the reported aggregate financial results of the corporation but would not diminish the capital available to support the main bank. If there are accounting questions on that, I would be happy to address them.

On the issue of the firewalls, our thinking was to go through step by step.

Mrs. ROUKEMA. I've been given a question here, and I think it's directly related to what you just said; so I'm going to interrupt now.

Mr. NEWMAN. Fine.

Mrs. ROUKEMA. How can they in the scenario that you've just outlined override the GAPP accounting requirements that are under the statute?

Mr. NEWMAN. OK. I think I know the issue you are referring to.

Suppose you have a subsidiary—whether it's the subsidiary of a bank or of the holding company really doesn't matter—that's in the securities business and has $100 worth of capital in it. If the legal structure is set up so that there is no further liability on the part of either the bank or the holding company with respect to that subsidiary's business, then if the subsidiary loses $150, let's say, the

limit of the liability is still the $100 that the parent has invested. It can just simply walk away from it and have no further liability. The accounting for that would not require a write-off of any more than the original investment. This has been checked out by the accounting people at the OCC, checked with the FASB——

Mrs. ROUKEMA. Mr. Newman, would you be willing to put that in writing——

Mr. NEWMAN. Oh, absolutely.

Mrs. ROUKEMA. Submit it for the record in writing, please, and then go on to the question, because we're running out of time, about the firewalls.

[Treasury's response to Hon. Marge Roukema's question can be found in the appendix.]

Mr. NEWMAN. The concept behind the firewalls thinking is to—and again, we'd be happy to work with you on this—is to walk through point by point the kinds of risks that might be spread from the depository institution as a result of it.

So one of them, for example, results from the extension of credit or guarantees. That is something that has been addressed for a number of years in Sections 23A and 23B of the Federal Reserve Act which we would support as a very good starting point for defining the kinds of restrictions, so that there would be very specific statutory limits on the degree of credit and the kind of credit that could be extended by the bank.

Mrs. ROUKEMA. Statutory limits.

Mr. NEWMAN. Similarly for capital contributions. There would be specific limits on the circumstances under which the parent bank, for example, could contribute capital to its subsidiary, and there would not be a call. In other words, the success of the subsidiary—they pass dividends up to the bank and strengthen the bank's capital, but there would be no legal situation under which the problems in the subsidiary could force a drain on the bank's capital.

Mrs. ROUKEMA. I hope you are right on that. We'll work together on the statutory provisions.

Mr. NEWMAN. Very good.

Mrs. ROUKEMA. Thank you.

Mr. NEWMAN. Thank you, Mrs. Roukema.

Mr. WYNN. Mr. Chairman?

Chairman LEACH. First, I would like to recognize Mr. Wynn for unanimous consent——

Mr. WYNN. Thank you, Mr. Chairman.

Mr. Chairman, I would like to request unanimous consent to submit written questions to the witness.

Chairman LEACH. Without objection.

Mr. WYNN. Thank you.

Chairman LEACH. Second, let me say that I am required to appear before the House Oversight Committee to defend the budget for the year, and I would like to ask Mrs. Roukema to take the chair briefly.

Mr. Kennedy.

Mr. KENNEDY. Thank you, Chairman Leach.

Welcome, Mr. Secretary, and I guess Mr. Secretary as well.

So, anyway, I have served on this committee long enough to see the committee act in the past on trying to break down some of

these issues pertaining to Glass-Steagall and have voted for legislation to do so, because I think when I first got here, we controlled something like eight out of the top ten banks in the world. We have dropped since then to one out of the top 50, which I think is number 26 the last time I checked or something along those lines.

I have never been convinced that just because you can get big, that that necessarily means that you are competitive. I started a little oil company that was able to beat a lot of the big oil companies, in many cases just because they were big.

But one of the things that I think has really been not dealt with—we talk about the need for allowing our institutions to get more competitive. The amount of credit that flows through any of these specific institutions doesn't seem to be of such a nature that can threaten our overall economy, which is ultimately why these separations took shape so many years ago.

But at this point—yesterday, Alan Greenspan talked about the fact that firewalls tend to melt away, and those were his words, in times of financial crises.

It seems that in my questioning of him yesterday, going back to the Continental Bank case, where funds flowed from Continental through to First Option, first he indicated he wasn't aware, and then he indicated he was aware, and then he wasn't aware, but the fact of the matter is that money flowed through the bank into what should have been a firewall, and I have no doubt that no matter how smart, Secretary Rubin and Newman, both of you are, that there's going to be some lawyers getting paid $800 an hour around here sometime in the next 4 or 5 years that's going to figure out a way to pierce whatever wall we create. I think that that's just the truth.

So the real question is whether or not we ought to be dealing with deposit insurance while we allow this sort of cross-fertilization, right? I mean, ultimately that is the only conflict that comes into play. And I'm wondering whether or not we ought not to be trying to cull out deposit insurance completely from institutions that want to get involved in these activities.

Maybe you have to go to something like that narrow bank model where you just say, listen, if you want an insured deposit, if you want to really make sure that your deposit is not going to get screwed around with because somebody makes a bad investment, we ought to allow a certain kind of institution to be set up to make those kinds of assurances and they are very, very limited, and then we ought to allow people that are interested in really getting out and competing internationally to do the same thing that every other country does. But it seems to me to be naive at best to think that you are going to be able to do both, and that's what all of these proposals ultimately end up doing, and what I sort of see as a major flaw in the structure.

I don't care how you devise whichever structure you want, no matter how we design it, somebody is going to figure out a way to pierce it. So I'm not exactly—I'll leave it up to either one of you to take the question. The question really is, can you design a system that you really want to tell us will work.

Mr. NEWMAN. Mr. Kennedy, why don't I try to respond to that. Clearly you are addressing key issues that need to be thought

through in this whole process. The question about the proper balance between the intermediation role that financial institutions play and their safety doesn't have an easy answer, but we do know that if we constrict our financial institutions too much, they will be unable to move the flow of savings into productive use in the economy.

We also know that if we are overly restrictive, they won't be able to compete as time goes on and the nature of instruments changes, the nature of markets changes, and we may find ourselves with buggy whip companies that can't survive.

Mr. KENNEDY. Let me just ask a real quick question, though. The fact of the matter is if I put my money in a bank today, I get a very, very poor rate of return on those investments. That is not why you put money in a bank. You don't put money in a bank to get a good rate of return.

Mr. NEWMAN. I guess that's a matter of competition, and clearly there are deposit services that are provided. But still banks do make loans to a variety of different parts of the society, both consumer loans and business loans, and somebody needs to perform that function.

The question about the—and this is something that is done in lots of other countries—there are a number of other countries that have deposit insurance mechanisms, not exactly like ours, but very similar, and those countries have much more open opportunities for both banks and securities firms to affiliate and to conduct activities.

I do grant your concern that if somebody really wants to violate the law, they have to be stopped; but that exists already. In a sense, the biggest risk, by far the biggest risk the banks have had historically, is just simply making bad loans or making loans that they shouldn't have made. If a bank is going to do that in violation of the law or of current standards, they need to be stopped. It's not clear that undertaking these new activities with the legal restrictions that we are proposing and that are conducted in many other countries is going to add any additional danger. As a matter of fact, far and away the biggest danger in the banking system is always bad loans.

Mr. KENNEDY. Yes. I'm not sure that giving them new powers is going to help that. But anyway——

Mrs. ROUKEMA [Presiding]. I apologize. I have to ask, now that we just have a moment—we've gone way over time, but we will give Secretary Rubin an opportunity to respond.

Do you have a response?

Mr. RUBIN. No. Mr. Kennedy, I think you have raised one of the central questions that we need to deal with. I would identify with Mr. Newman's response, and I think a number of the Members have raised a similar question.

Mrs. ROUKEMA. All right. Thank you.

Our colleague, Mr. Roth, from Wisconsin.

Mr. ROTH. Thank you, Madam Chairwoman.

Secretary Rubin, why should our community banks be for a repeal of Glass-Steagall?

Mr. RUBIN. Why should they be—I'm sorry?

Mr. ROTH. Yes. Why should they be in favor of a Glass-Steagall repeal?

Mr. RUBIN. Smaller community banks?

Mr. ROTH. Yes. I'm just trying to help you. I am looking for an answer for the objections they give me.

Mr. RUBIN. It's a very interesting question, actually, and it's one that we've talked a fair bit about, the impact on the smaller banks. I think you can envision two kinds of impacts. On the one hand, if I were a smaller bank, it would seem to me that what I would do if this legislation were to pass is try to make my small bank a one-stop shopping center, and I would try to develop affiliations with insurance companies, investment banking firms, brokerage firms, and really become the one-stop shopping center in my area, my community or whatever it might be, so that somebody could come to my small bank and get the benefit of the services of all of these large institutions in these different areas. That would be what I would call the sort of business proactive approach.

I suspect there will be other small banks that will view it as a threat because they have an existing business; they are not particularly interested in being proactive in thinking about their business; and they feel that what will happen is that these national institutions will set up competitive capabilities.

So I think you could envision two types of effects, and actually, in some sense, separate out the strategic forward-looking banks from the non-forward-looking banks; although let me say in fairness, there also could well be extremely well run smaller banks that have a very important niche, that are greatly trusted in their community, and they simply feel, and rightly and successfully feel, that that's the way they should continue to operate.

Mr. ROTH. Well, I think many of the community banks will feel threatened, you know, with Glass-Steagall repeal or expanding or whatever we do with it; so I was just interested in your viewpoint and what you thought of it.

This bank in Britain the other day that was brought down, any problems with us expanding and banks getting into all kinds of other businesses? I mean, could a single individual today bring down J.P. Morgan and why or why not?

Mr. RUBIN. Could we say a hypothetical rather than using J.P. Morgan? [Laughter.]

Mr. ROTH. OK.

Mr. RUBIN. If you've run one of these kinds of institutions, which I did, it's really a very interesting situation. You do wonder a little bit how all of that activity took place over the period of time that it must have taken place without a certain degree of managerial focus and curiosity.

Mr. ROTH. You know what concerns me about changing Glass-Steagall: All of a sudden, we run into trouble and the Secretary of Treasury is going to say, you know, I don't know what happened here in these American banks.

Mr. RUBIN. Let me make a comment that's a little more categorical, perhaps, than I should. I think that with the systems that exist in this country and the kinds of controls that are required by regulation and that are reviewed by regulators both in the institutions and, interestingly enough, at the exchanges, because what

happened to SIMEX, the Singapore Exchange, also raised some interesting questions, it seems to me that what happened there could not happen here. Although you never want to say something couldn't happen, I cannot envision how it would happen here. You can have very large accidents, and there are securities firms and, for that matter, banks that have had very large accidents, particularly when you have what's now being referred to as a rogue trader. But I think something of that magnitude would not be possible under the system that we have here, subject to the caveat that in some sense nothing is ever impossible.

Do you agree with that, Mr. Newman?

Mr. NEWMAN. Yes.

Mr. RUBIN. I mean, you are raising an extremely important question that we—independently of this whole Glass-Steagall question—have been talking about.

Mr. NEWMAN. Let me just add a couple of thoughts to it. I absolutely agree.

First of all, the U.S. banks already have the authority to transact futures transactions and have had for quite some time, maybe not the exact same ones that were used in that case, but large, large volumes of futures transactions.

In this country, the futures exchanges have the kinds of controls that Secretary Rubin just mentioned, and we have gone through them with Chairman Schapiro of the CFTC just in these past few days, that would have, as the Secretary said, spotted these problems long, long in advance. So the controls are substantially better.

That does raise the question, I suppose, that—and, by the way, this is not a new feature. This is not, really, in a sense, relevant to the Glass-Steagall debate because banks already can deal in futures. But it does raise the question of could a bank be dealing in one of these foreign exchanges in some country where the controls on the exchanges aren't quite so good. In that case, you need to rely on the internal controls of the bank.

Well, under our bank regulations, there are internal control requirements that are examined very intensively that require separation of duties and reporting functions that apparently were not in place in this particular case, and that is just part of our regulatory structure.

Mr. ROTH. Thank you.

Mrs. ROUKEMA. Mr. Flake, please.

Mr. FLAKE. Thank you very much. I would like to welcome both Secretaries here this morning.

Obviously, by virtue of the fact that over these last 9 years I have been participating in the various discussions as it relates to repeal of Glass-Steagall, and the fact that I'm working both with Mr. Leach and Mr. Baker and now have an opportunity to see your bill, we know that we're going to try and move forward at last to do what I think is important for the American banking system.

However, there is a great deal of concern on my part. We're talking a regulatory question here, and I know that when you get into questions like the BIF/SAIF issue, you're talking about a financial question.

Yet, for me, it is a significant question, because the impact of the movement, as Citibank has already indicated that it's moving from

the middle segment of the market, it's going to put a great deal of its emphasis in the international market area, and knowing that we are going to probably face, if there is nothing done to repair what we anticipate will be a disparity between those two regulated entities—it seems to me that even as we move this process, we cannot afford to leave on the backtrack the whole question of how we resolve that BIF/SAIF question, because as we get more powers for one segment of the market that is already going to be advantaged and we give them more advantages while we leave another segment behind, it seems to me we're saying to that portion of the industry that you need not exist.

So I would like to hear your comments on how we, understanding that I'm fully supportive of Glass-Steagall reform, how we move that process forward, but at the same time move forward in a process that ensures that there is not a segment of this industry that serves a very important segment of the marketplace that could be left out of the whole process, to make sure that we find ways of not including them in Glass-Steagall per se, but inclusiveness that makes sure that they survive, because I think it's important for many communities that they do.

Mr. RUBIN. Mr. Flake, you are raising, again, a very important question, and let me take a first shot at it and then turn it over to Secretary Newman.

My view is that while it is true, and I think desirably true, that legislation of any of these variants of the repeal of Glass-Steagall will focus even more tension on the international competitive arena and better equip our banks or financial institutions to function in those arenas, I think it will also create opportunities—and this goes a little bit to Mr. Roth's question, I guess—for institutions to function more profitably with the smaller and middle market in banking because they will be able to bring multiple services to bear. By bringing multiple services to bear I think they will be able to function in a more profitable fashion. So I think we can actually accomplish both purposes with one legislative proposal.

There is always the question that goes maybe a little beyond what you were asking about the areas that simply aren't served for various kinds of reasons. That's why we had the Community Development Financial Institutions legislation of last year and why we believe very strongly in CRA and intend to continue to vigorously pursue CRA.

Mr. FLAKE. But I think the question still is, even if you provide an opportunity for this expansion and you have the inequity that exists between BIF/SAIF, if, in fact, that inequity continues——

Mr. RUBIN. Well, yes.

Mr. FLAKE. Then I think you still have—I'm not raising a CRA issue; I'm raising a basic fundamental banking issue as it relates to segments of the marketplace that just will not be served.

Mr. RUBIN. But the BIF/SAIF issue—and the problem that exists because of the difference between them and the different situations right now—is a very important question which I will turn over to Secretary Newman.

Mr. FLAKE. OK.

Mr. NEWMAN. Thank you, Secretary Rubin.

Mr. Flake, we clearly do agree it's important, as we said before. I mean, we're happy to participate in trying to resolve what you know is a very, very difficult problem.

With respect to this particular bill, however, we would suggest that, given the nature of the two bills, it would not be wise to put them together. They really need to be addressed as separate items, although we acknowledge some relationship.

The one thing that we do propose, and it's spelled out a little bit more in the written testimony, is that the existing unitary thrift structure not be interfered with, that under the circumstances it would be unwise to put still more of a burden on some thrifts who are trying to be successful in a difficult environment, and as long as the 10 percent limitation on commercial loans by those thrifts is maintained, we would not see it as particularly dangerous and it's something that could be continued as part of this legislation.

Mr. FLAKE. Yes. And I wouldn't argue for merging them, but I would certainly hope that we would not let December come upon us and we have not at least, even as we are giving much attention to Glass-Steagall, not at least giving a great deal of attention to what happens if we don't resolve the issue, because I don't think it's going away.

Thank you very much, Madam Chairwoman.

Mrs. ROUKEMA. Mr. Baker.

Mr. BAKER. Thank you, Chairwoman Roukema.

Mr. Secretary, yesterday we had an interesting hearing as well that gave good insight, I think, into some of the philosophic issues in this current debate.

Chairman Greenspan, for example, said he did not express any philosophical objection to the blending of commerce and finance, although he could not express a regulatory system today that made him comfortable.

Chairman Helfer said we should proceed only on a product-by-product basis, not including insurance as a defined commodity in her comment, but suggesting that that, for example, might be a step that could be taken.

Comptroller Ludwig talked about the advantages of product diversity and producing income streams for the bank not otherwise available.

Director Feichter talked about the experience of the unified thrift to which Mr. Newman just referred and in fact said that diversified ownership provided stability to those thrifts which otherwise might have encountered difficulty had they not had that experience.

It seems to me that there is only a difference in opinion as to how we get there, not whether we should go or not.

Yesterday I suggested to Chairman Greenspan that rather than take a step, we should perhaps all get together and go for a walk. The walk should discuss what's going on in the real world.

For example, in defining what is a financial company in your legislation, would a software company selling bank service hardware and software who also is in the entertainment business be a finance company or in commerce? A person who happens to be in the credit card-issuing business who might be in the travel business as well and sell suitcases, are they in finance or are they in com-

merce? Someone who perhaps is in the insurance business who might own a real estate brokerage operation, what are they?

My point is that the camel has long since been in the tent. We are like the ostrich looking to put our head in the sand and the beach is gone. The world around us has changed and we are now arguing the niceties of whether part A or part B should get in rather than look to the issue of product diversification, which is really what this argument is about.

The questioning of why would anyone want to own a bank frankly surprises me. Why would anyone want to own anything, then? Simply buy shares; don't ever have ownership interest. It goes to the core of what our system should be about: diversification and free enterprise, allowing people in America to invest capital as they see fit for the purpose of making a profit. It's getting more difficult these days and somewhat in troubled theory in some corners as to whether profits are advisable or not, but this is about the core of where our financial market should go.

In my view, we should not proscribe areas of action off the table. If we were doing that, I think you should act quickly on derivatives. But we allow those institutions to engage in risk-taking because we feel we have appropriate controls, they are properly capitalized, and it does not present systemic risk to the inherent qualities of a financial institution.

On the other hand, we should look very carefully at the risk of ill-advised business activities. I am not saying we should careen blindly over a landslide into the taxpayers' pockets. Far be it for me to suggest that, given the experience of my State in the last 10 years, that we should turn away from those experiences. What we should do, then, is look to the advisability of what risk should taxpayers insure if we are to allow financial institutions to engage in new products and services and not concern ourselves as much about the nature of those business activities.

I do not have in the current legislation a plan to put before you this morning, but I will forward something to you that is exactly on that point. I think we should allow community bankers to remain community bankers, fully insured as they are today, enjoying life as they see fit; and if we want to open a new day of product diversity for those who wish to be forward-looking, as you have described them, let us do so with caution on taxpayers' insured risk.

Can you respond?

Mr. RUBIN. Mr. Baker, leaving aside the ostrich and some of the imagery, which I may have lost at some point or other, if I understand you correctly, and I think I do, the general thrust of your comment is one that we would agree with.

I think that the questions will come with respect to some of the specifics, We think we should have a system that, as I described in my opening statement, will bring our financial services industry in accord with the current realities.

Mr. BAKER. Just a quick follow-up, if I may. I'm on orange and going to red quickly, I have a feeling.

Define financial company.

Mr. RUBIN. Well, that's a very good point. I actually think I made that comment somewhere along the line. If I didn't, I meant to.

In the first place, what is a financial service? You pointed out the ambiguity and the difficulty, and that difficulty will be ever greater as time goes on because we live in a rapidly changing world. That is why we suggested a National Council on Financial Services, which is an interagency policy forum, something I think you are not totally unfamiliar with as a concept, which could deal with that issue as we go along, because I think some of these things simply are not set in stone. We need a dynamic process for dealing with a dynamic industry and questions that by their nature are dynamic. I think you wouldn't disagree with that.

Mr. NEWMAN. If I might add, Mr. Baker, just briefly to that——

Mrs. ROUKEMA. Very briefly.

Mr. NEWMAN. Fine, Madam Chairwoman.

The question of ownership is a legitimate one, and both Secretary Rubin and I share your view that there ought to be as much flexibility as possible in the private sector, and the only time you want to cut off flexibility is when there is a genuine public policy need to do so, a reason to do so. The question here is one of balancing potential synergies against the risk and the regulatory structure that would be required. Clearly if an industrial firm has some kind of synergy it could see with another company it wanted to buy, there's a lot of reason to do it.

It's hard to see the synergies in some of these cases, and it is easy to see potential abuses that we're not ready to deal with. And again, as the Secretary said, that's one of the reasons that we thought the idea of a council to try to make some of these judgments made a lot of sense.

Chairman LEACH. [Presiding.] Yes, Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. Thank you. First, let me just follow up on something because I feel that Congressman Kennedy's question was not directly answered. One of the major concerns with Continental Illinois Bank transferring these funds was the fact that it was being done under the very noses of the FDIC and OCC regulators who were monitoring real time transactions at the holding company.

So there clearly is evidence that despite the firewalls and the regulators' physical presence at the site, abuse occurred. Your response to the question is—and I wrote it down—"These questions have been raised and we recognize it is a problem." This is really not an answer that satisfies most of us who are concerned about the potential for abuse.

Mr. NEWMAN. OK. Let me try to amplify on it, because clearly more is required. As you said in the First Options case, as I understand it, what happened was there was a violation of the rules, it was caught very quickly and rectified very quickly.

I guess the point here is that if an institution is going to violate the rules, there are a lot of risks it can create in the current circumstance, and it is not clear to us that there are material new risks for somebody who would violate the rules, nor is there a great concern that the rules cannot be properly monitored. It is one of the reasons, for example, that we join with Mr. Leach and Mr. Baker in terms of thinking that functional regulation makes sense. The SEC is the most expert at securities regulation not to be on top of it.

Right now, if a bank wanted to violate the rules, there are lots of rules it could violate. We haven't placed a regulatory structure that would catch it very quickly, and in fact the First Options case was caught very quickly, but there are lots of things that could be done. The question is, do you have a regulatory structure that can find them promptly and take the proper corrective actions?

Ms. ROYBAL-ALLARD. And do we, or will we?

Mr. NEWMAN. I believe we do and I believe that the proposals that we are talking about here today would have them in the new structure.

Ms. ROYBAL-ALLARD. In my district we have only 55 branches serving a population of about 571,000 as compared to a more affluent area like Pasadena that has 50 branches for a population of 138,000.

My question is, as we are modernizing the banking system to reflect these new market conditions, would it not be appropriate to remedy the historical neglect of financial services to minority and urban areas, particularly in light of the fact that banks are going to profit and be able to thrive much more?

Mr. NEWMAN. We certainly, as Secretary Rubin noted before, were very pleased last year when the Community Development Financial Institutions bill was passed, which was intended to address a number of these problems and hopefully, if the funding can be maintained, will provide a basis for leveraging private sector funds and bringing them to the kinds of issues that you mention.

Also, as Secretary Rubin mentioned before, there may be some opportunities for banks that are now operating in communities where there is not an easy access to securities services, but there are growing businesses that could use different kinds of financing to actually have a better way to obtain that financing.

In other words, a local bank in a community might now be able to provide a wider range of services for a growing company in that community than was previously allowed.

Ms. ROYBAL-ALLARD. I guess what bothers me are the words "might," and "we hope." There is nothing to assure me that there is going to be any kind of protections in place for the communities that I represent. Hoping for a positive outcome is very, very troubling.

Mr. NEWMAN. You raise a very good question. Under current law we have the community development financial institutions, we have CRA and we have fair lending, which is the law of the land.

As you know, we are very strong supporters of CRA and of the fair lending laws. There is nothing beyond that envisioned in this proposal. On the other hand, if you had thought that we should look at them, we obviously would look at them in a serious and thoughtful way.

Ms. ROYBAL-ALLARD. Since CDFI funding has been targeted for rescission, how is this going to impact——

Mr. NEWMAN. We didn't target it for rescission.

Ms. ROYBAL-ALLARD. I understand that. What is going to be the result in terms of the concerns that we have?

Mr. NEWMAN. Well, recision of the funding will obviously adversely affect the program. No, I think it is a very serious issue. We believe very strongly—and I will add I personally believe very,

very strongly—that the CDFI program is a very good program, and we feel very strongly about having the funding, and we feel very strongly those funds should not be rescinded. Obviously, if they are rescinded, that creates a terrible problem with respect to what we think is a very important program.

Ms. ROYBAL-ALLARD. The problem being you would not be able to monitor?

Mrs. ROUKEMA. [Presiding]. I think we are going to have to conclude this questioning.

Mr. NEWMAN. What?

Ms. ROYBAL-ALLARD. I was trying to get you to elaborate on what that terrible problem would be.

Mrs. ROUKEMA. Excuse me, my colleague. I think we are going to have to conclude the questioning and go onto the next question.

Mr. FRANK. You can do it in the veto message. You can answer that question in the veto message on the rescission.

Mr. RUBIN. That occurred to me, Mr. Frank. I don't want to prejudge whether the President is going to veto or not veto, but he cares a lot about this program.

Mrs. ROUKEMA. It is an important issue, but not on target with respect to this legislation.

Mr. Lazio.

Mr. LAZIO. Thank you, Madam Chairwoman. Good morning. I want to follow up on some of dialogue that you had with my colleague to the right, Mr. Baker, in trying to define what a financial company is.

I had a dialogue with Chairman Greenspan yesterday about his definition regarding similar language in Mr. Leach's proposal.

I wonder, Mr. Secretary, if you could tell me. In your statement you discussed the affiliation of an FDIC-insured deposit institution with, among other things, another financial company. What would that include? Would that include, in your opinion, a credit card company?

Mr. RUBIN. The answer to your questions is yes, a credit card company.

Mr. LAZIO. Finance company?

Mr. RUBIN. Yes, sure.

Mr. LAZIO. GMAC, Ford Credit, those types of companies?

Mr. RUBIN. Yes.

Mr. LAZIO. You can foresee that. And in terms of insurance companies, could you foresee an affiliation where every type of insurance activity is undertaken?

Mr. RUBIN. In general, we are in favor of affiliation with insurance companies. I think that—maybe this is what your question is getting at—there are questions about certain types of property and casualty insurance. Because of the risks that are involved, I think we all need to look at it further together, particularly when you have property and casualty companies that are very specific and limited in the kind of risks that they insure.

Mr. LAZIO. Speaking about risk, do you agree that our primary focus needs to be on prohibiting or limiting risk rather than, as a primary objective, dealing with the activities that a bank may, through a subsidiary, involve itself in?

Mr. RUBIN. Let me try to go at that just a slightly different way, if I may. This is the way we've approached it, and I think it is sensible, and that is to think of what it is we are trying to accomplish, and how we can have a financial services industry that is as modern as the conditions have become, and then, within the context of that set of decisions, ask what we can do to make sure that we maintain safety and soundness and in fact, we think, enhance the safety and soundness through diversification.

I don't know if that is responsive or not, but that is our analytic framework.

Mr. LAZIO. I'm afraid in a 5-minute timeframe—I would like to get into it more with you. Maybe I will do that in writing.

I want to get back to some earlier testimony when you were talking about firewall relative to a holding company.

Mr. RUBIN. Incidentally, I'm talking about a stand-alone finance company. Obviously, if a finance company is owned by a corporate parent, for example it is Ford Credit, and it still has Ford, that is a different question.

Mr. LAZIO. I understand, right. In a situation where you have a bank who affiliates with a, let's say, a non-bank subsidiary, you would define that as a financial company or an insurance company or a securities firm, and in terms of potential drain on bank capital, that, I think if I understood you correctly, you were saying that the capital investment a bank might make in a subsidiary would be the limit of its exposure with the firewalls that you would envision?

Mr. RUBIN. Yes. What we said was that the investment in the non-bank affiliate would not count as part of the capital of the bank. As a consequence, if the non-bank affiliate went into bankruptcy and was wiped out, it would not affect the capital of the bank. That is right.

Mr. LAZIO. So the bank would be limited to its investment?

Mr. RUBIN. That is correct, though—the answer to that question is yes, except the investment once made would no longer count as part of the capital of a bank.

Mr. LAZIO. So help me understand why it makes a difference given the fact that the profits presumably would flow one way from this non-bank subsidiary to the bank, but the potential exposure would be limited to the amount that a bank would contribute to its subsidiary, why it makes much of a difference whether you have a securities firm, an insurance firm or a commercial firm or widget firm that is non-securities, non-insurance, a non-financial company in nature, given those firewalls, from that perspective?

Mr. RUBIN. You are getting at the question of why we would not be in favor of a non-financial firm being——

Mr. LAZIO. I'm just trying to rationalize those two things.

Mr. RUBIN. OK. It does strike us, and I addressed this a little bit in my opening statement and then Secretary Newman expanded on it, that with a non-financial firm——

Mr. LAZIO. Can I just stop you?

Mr. RUBIN. Yes.

Mr. LAZIO. I am going to try and cheat a little bit and ask you another question so you can get a chance to answer both.

Mr. RUBIN. You are already in your red light district, but in any event.

Mr. LAZIO. Maybe you could just answer the question, and I will ask you privately the other questions.

Mrs. ROUKEMA. I think we will have to do that because I'm afraid we are going to be interrupted with some votes very shortly. So Secretary Rubin, will you just respond to his last statement?

Mr. RUBIN. Sure. In a word—we would be happy to expand on this later—we think that with the non-financial firms, there are more kinds of supplier and customer relationship of a kind that might involve pressure on the bank to do things that it shouldn't be doing than you have with a financial firm; so on the one hand, we think there is greater risk, and we don't see any benefit, we don't see any synergies or commonalities, and so we see no additional benefit and we see some possible additional risks.

Mr. LAZIO. It seems to me the market would punish that.

Mrs. ROUKEMA. Thank you.

Congresswoman Velazquez.

Ms. VELAZQUEZ. Thank you, Madam Chair. Secretary Rubin, my question will follow the line of Lucille Roybal-Allard's question to you before. A number of questions were raised yesterday regarding Glass-Steagall reform and credit availability in low and moderate income minority communities.

The communities that I represent in New York City are repeatedly cited as underserved if not abandoned by financial institutions. The CRA is helpful, but not very effective. CDFI could improve the availability of credit, yet the majority party wants to zero out CDFI funding.

What are the Administration's view regarding Glass-Steagall reform and the availability of financial services and credit in all communities? Is there a direct connection or is it indirect and trickle down?

Mr. RUBIN. I think I would go at it a little bit differently, if I may, and that is I think in terms of dealing with the underserved communities—although I do think there is a very real possibility that the repeal of Glass-Steagall could be helpful by virtue of the same thing that I discussed before, I guess, in response to Mr. Roth—that offering the opportunity to provide one-stop shopping might actually create profit opportunities that don't exist today.

So I think there is a possibility of being helpful, but basically in terms of underserved areas, we have always felt—at least it seems to me that we have felt—there are three prongs to our approach.

One is CDFI, and as you say, the rescission is a threat to that program. It is a program that the President believes very, very strongly in. He talked about it in the campaign, he talked about it once he got elected, we got it enacted, and it is something that he feels very strongly about.

Ms. VELAZQUEZ. You can tell him I will lend my pen for a veto.

Mr. RUBIN. I will mention that.

Mr. FRANK. But under the ethics laws, you will have to give it back. [Laughter.]

Mr. RUBIN. I don't want to get into the question of what he is going to do about that whole area. That is obviously his judgment. And there is CRA, and I agree with you, it is not as effective as

it ought to be. On the other hand, as you know, we've been trying to revise regulations, and we will certainly do our most to make it work. And then there are the fair lending laws, which are the laws of the land, and we have tried to be vigorous in enforcing them, so that is how we approach that issue.

Ms. VELAZQUEZ. What evidence suggests that bank reforms along this line promotes development in underserved communities, Secretary Rubin?

Mr. RUBIN. Excuse me?

Ms. VELAZQUEZ. What evidence suggests that bank reforms along this line promotes development in underserved communities?

Mr. RUBIN. It seems to me logically it should. Whether the evidence exists or not, I do not know.

Do you know?

Mr. NEWMAN. As discussed before, I think, Congresswoman, these are hopes, and that is legitimate. The truth is this particular bill is really focused on removing some inefficiencies and some restrictions. It is not specifically targeted to underserved communities.

The CDFI bill was specifically targeted and passed with very bipartisan support in this committee. Even though we would hope there would be some benefits to it, just as CDFI was really not intended to help remove restrictions, but to target underserved communities, this bill is really more targeted toward removing restrictions, and the two in a sense complement each other.

Ms. VELAZQUEZ. Mr. Secretary, I know that you said that you didn't propose the recision of all CDFI funding. Are there any other bank reform measures that this committee could consider to encourage credit, investment and development of low- and moderate-income minority communities that goes beyond CRA?

Mr. RUBIN. I don't think, Congresswoman, at this point there is anything—I am trying to think of all the things we have been working on—anything that I would have to suggest that would accomplish that purpose.

Ms. VELAZQUEZ. Thank you, Madam Chair.

Mrs. ROUKEMA. Thank you very much.

Congressman Bereuter.

Mr. BEREUTER. Secretary Rubin and Secretary Newman, thank you very much for your testimony. I had to go and testify in front of another committee so I hope my question has not been asked but I would like to begin by mentioning that yesterday the FDIC in its testimony pointed out the costly failures associated with the thrifts in their use of subsidiaries to conduct certain activities.

Is the experience of the thrift industry in the 1980's a good argument for conducting securities activities under the bank holding company structure rather than subsidiaries and, if not, why not?

Mr. NEWMAN. Mr. Bereuter, first of all, the problems that the thrifts had were special in lots of ways, including lack of regulatory attention in focused ways, including the fact that some of the legislation that has been passed since then was not in effect at that point in time. We believe that there are far more protections right now. The banking industry is very healthy and well-capitalized.

Let me take this opportunity to comment more substantively on the underlying question that has come up a number of times about

the nonbank affiliates versus the bank subsidiary, which I think you are driving at.

Secretary Rubin mentioned earlier that this is an issue that we think is a valid issue, it is not the forest we are talking about, it is one tree in the forest but it is one that ought to be addressed. We should also make it clear that in either case, the SEC would be the regulator as we have proposed it, so it is not a question of would there be different regulators. In fact, the SEC would regulate a securities subsidiary, regardless of where it was located. And safety and soundness of the insured depository institution is paramount in our consideration.

We have talked a little bit about some of the specifics, about how we would approach firewalls, which we do believe ought to be in the statutes, and other protections that would protect the insured depository institution in either case. If we weren't able to come up with satisfactory safety and soundness protections, then it shouldn't be done. We believe it is possible.

One of the interesting things is that nowadays, there is tremendous complexity in the corporate structure of bank holding companies. I used to be the CFO of two very large ones and it is not uncommon to see literally hundreds of subsidiaries. It is very complex, it is very wasteful, it is a tremendous amount of overhead and it actually creates more risk because of all the intercompany transactions. These are the result, usually, of legal requirements.

I think all of us here are trying to minimize government interference in business activities unless there is a very good reason for it. If there is a good reason, fine. If there is not, there is no reason to create the complexity.

The idea of having a bank subsidiary is not a radical new idea. In fact, other countries generally operate that way. Our bank holding company structure is extremely unusual internationally even though these other companies also have deposit insurance equivalents. As a matter of fact, overseas, U.S. banks operate what are called Edge Act subsidiaries, and have for a number of years, that do securities business as a subsidiary of the bank. It has operated just fine. There haven't been any major problems whatsoever for years.

State banks, as a matter of fact, in some States under the FDIC and State regulations, actually have subsidiaries that are in the securities business and have been for years, again without major problems.

The main issue here is the control system. Sometimes the control systems are better on the banks, sometimes they are not. That is really a management decision. And again, with this philosophy of not having government tell management what to do unless there is a necessity for it, we just think it needs to be thought through very carefully in light of the reductions.

Mr. BEREUTER. I would like to—I yield to the gentlelady.

Mrs. ROUKEMA. I would like to point out and I will give you a little more time. In the context of what you said, Mr. Newman, I want you to know though in terms of regulatory burdens, we have taken the precaution here to exempt bank regulatory authority from the risk assessment and the moratorium. I think we did that judiciously because of safety and soundness concerns.

Mr. BEREUTER. I thank the Chairwoman. That is exactly right, of course, and I think it was a good move, necessary.

One more question, if I might, and that is on the subject of foreign banks, how would Treasury's Financial Service Modernization Act treat foreign banks?

Mr. RUBIN. Our view is to have national treatment.

Mr. BEREUTER. Exclusively, totally? So this is entirely consistent with what we committed ourselves to as we talked to the European Union about their Second Banking Directive? We should have not——

Mr. RUBIN. I actually am not familiar with that. Are you, Mr. Newman?

Mr. NEWMAN. It is fundamentally consistent, Mr. Bereuter, although as you know we have taken the position that it is also important for the Administration to be able to assure that there is reciprocity in terms of international treatment or not. Our belief is the right way to do it is to set the right example. But in those cases where there were flagrant violations of reciprocity, we would want to be able to address that.

Mr. FRANK. If the gentleman would yield?

Mr. BEREUTER. I yield to the gentleman.

Mr. FRANK. The House, as you know, agreed with you last year. We—the Senate was the one that kept stopping it but we did do that exactly as you proposed last year.

Mr. BEREUTER. That is correct, I believe.

Thank you. Thank you, Madam Chairwoman.

Mrs. ROUKEMA. Thank you. Mr. Barrett.

Mr. BARRETT. Thank you, Madam Chairwoman. I know that a lot of the questions have been asked and if I could just deviate for a moment, and I do not even know if Mr. Rubin is interested in commenting on this. It is totally off the subject of what we are talking about today.

But in the last several days, some of my colleagues have attacked you personally with respect to the role that you have played with regard to the President's Mexican policy and I am not someone who is particularly supportive of what the President has done. At the same time, I certainly think the debate should be on the merits of the issue as opposed to personal attacks.

It is my understanding that you have severed your ties with Goldman Sachs, you have no financial interest at all. Again, if you do not want to comment on this——

Mr. BACHUS. Madam Chairwoman?

Mrs. ROUKEMA. Yes. Mr. Bachus.

Mr. BACHUS. Is the proper subject of this hearing going to be the Mexican proposal? I mean, if it is——

Mrs. ROUKEMA. No. Does the——

Mr. BACHUS. If it is, I would like an opportunity to respond to him. But I would hope that we could keep this hearing on the subject that is before us.

Mr. BARRETT. Madam Chairwoman, as I indicated, I just—since Mr. Rubin was attacked, I simply wanted—if he wants the opportunity to comment on it, I would like to have him have the opportunity.

Mr. BACHUS. I withdraw my objection if that is indeed what you are giving him the opportunity to do.

Mr. BARRETT. Yes. And, again, if he does not want to do so, I do not think he should but I do not think anyone should be attacked——

Mrs. ROUKEMA. I don't know, we have the agreement of both parties here. I want to say this is irregular and out of order as to the proceedings of the committee.

Mr. RUBIN. Perhaps I can solve your problem, Madam Chairwoman.

I appreciate your comments, Mr. Barrett. The Chairman at the beginning of the hearing was kind enough to say that he felt that I had conducted myself in entirely appropriate fashion throughout this entire matter, and I don't think I need to comment any further.

Mrs. ROUKEMA. That is fine. Would the gentleman go on then with his question regarding——

Mr. BARRETT. No, I just wanted to have him have that opportunity in case he wanted to say anything. And I have no further questions.

Mr. RUBIN. I appreciate that.

Mrs. ROUKEMA. Thank you.

Mr. Bachus.

Mr. BACHUS. I am going to talk to you about insurance.

Mr. RUBIN. I would be delighted to discuss any subject you would like.

Mr. BACHUS. Mr. Secretary, one of the most difficult issues that I personally have on this committee is banks and the insurance business. Of course, the banks have strong feelings that they should be permitted into the business and independent agents particularly have strong opinions diametrically opposed.

You suggested that banks' direct subsidiaries ought to be able to sell insurance, I believe, at least give an indication of that.

Mr. RUBIN. Correct.

Mr. BACHUS. You have indicated in your testimony that underwriting, I think your statement is banks, moreover with certain insurance activities, banks do not assume the risk of underwriting and the banks' capital remains unimpaired.

From your statements, I want to talk to you just specifically about what insurance activities bank subsidiaries ought to be allowed to do and what they shouldn't. Let me just give you an example and I think it is the one that we will see time and time again and that is when a bank insurance subsidiary sells insurance, insuring some collateral that the bank is holding on a loan.

In other words, somebody comes in a bank——

Mr. RUBIN. For example a mortgage on a home or something like that?

Mr. BACHUS. Yes, a mortgage on a home or they come in and they finance a car and the bank's subsidiary insures that car and then you have a loss. I can foresee all sorts of conflicts coming up. You know, the insurance subsidiary wants to determine whether it is a fraudulent claim or how much they ought to pay, the bank, they have different interests, they would obviously like the claim

honored and would you just elaborate a little further on where you think that line of permitted and nonpermitted should fall.

Mr. RUBIN. I think you are getting into a set of questions that we think are extremely important and that we are going to have to pursue together beyond the ambit of this hearing because of the time here.

Mr. BACHUS. Sure.

Mr. RUBIN. Are you getting to the question of whether there might be a tie-in in the initial offering of the insurance or are you worrying about what happens after there is a foreclosure, or both?

Mr. BACHUS. Well, both. But I think let's just say at the point of a claim. Are you going to allow the bank subsidiary to participate in the claims process if the loss is at the bank itself?

Mr. RUBIN. I think the answer to that would have to be, yes, but let me ask Mr. Newman.

Mr. NEWMAN. Well, at the moment, Mr. Bachus, the credit insurance is something that is legal in the bank and is provided as a service. It is important not to have any coercive tie-in but, as a convenience, credit insurance is available.

Clearly, if the underwriting were done by an affiliated insurance company, then that affiliated insurance company would have to handle the risk at the ultimate close. Again, the firewalls and other protections we talked about are intended to and we believe will, effectively protect the insured depository institution in that event, even if the insurance company has to absorb a loss.

However, I should again mention Secretary Rubin's caution, with respect particularly to certain kinds of property and casualty insurance where there may be very large losses, like in a hurricane or an earthquake, that we think one needs to address that very carefully because of the potential for very large losses and that may be an exception.

Mr. BACHUS. Have you all done some preliminary groundwork in determining what type of activities ought to be permitted and what shouldn't? Do you have any specific proposals at this time? You know, we are considering letting a bank subsidiary get into the insurance business but we really don't know what activities it would be permitted to do or not do, so it is sort of hard to judge on all these theoreticals.

Mr. RUBIN. I think in the broadest sense, the distinction that we have been focused on, though, as you correctly say there are also subset issues that one might want to deal with, is the question of property and casualty insurance, particularly where the property and casualty company is involved in a relatively narrow line of coverage because that is obviously where the risks are greatest. While we do not have a definitive view on that, we do have the view that that is something that needs to be looked at with a lot more care.

Mr. BACHUS. And I think it sort of needs to be looked at and has to be looked at before we decide whether we are going to give bank subsidiaries the right to engage in certain insurance activities because, ultimately, this firewall has to be tested and every time there is a claim where the bank and the bank's subsidiary may have different interests. I would just say to you, would you please keep us advised, any information that you have done, any prelimi-

nary groundwork you have done, I would certainly like you to share it with us.

Mrs. ROUKEMA. Perhaps I could request that you do that in writing for the committee, as you keep us up to date on your deliberations on this subject.

Mr. RUBIN. We would be delighted to.

Mr. BACHUS. And I will make this—the insurance companies have recently sort have shown a willingness to agree to this type of thing, so have the banks. But, you know, their willingness doesn't make it something that we just endorse.

Mr. RUBIN. No, and we would agree with you, that of everything we have discussed, the issues that are least clear in our mind are the ones that you are raising with respect to some insurance activities and the risks that they may create, so we would be delighted to respond in writing as we further think this through ourselves.

Mr. BACHUS. Thank you.

Chairman LEACH. Mr. Frank.

Mr. FRANK. I thank you Mr. Chairman. Before I start, I want to say I do appreciate your interest and fairness in rehabilitating reputations, particularly want to talk about this subject of an attack that you have brought back into good favor under the 5-minute rule because last year the 5-minute rule was the subject of great denunciation often in this committee. People thought strict adherence to the 5-minute rule was a sign that we didn't have fair deliberations and I am glad to see that, under your chairmanship, the reputation of the 5-minute rule has come back and we are adhering to it and it is apparently no longer considered a sign that people are interfering with the deliberative process.

Mr. Rubin, one thing I wanted to mention is we hear a lot of predictions of doom if we were to act on your proposals and my problem is I think we have in the public debate a built in negativism where doom predictions are welcomed and people almost are incentivized to make them. I would ask you to reflect back in 1992, after this committee had passed the FDIC-related legislation which sought to deal with the situation of commercial banks and to forestall serious problems with failures of commercial banks, there were widespread reports in the financial media that this was a sham. In fact, the Bush Administration and this committee on a bipartisan basis were being attacked. We were told there would be a December surprise, that despite our efforts there would be great carnage in the financial institutions and that once again predictions would prove to be a sham.

I hope that when people—some of the same people who predicted disaster in 1992 will be predicting similar disasters about this legislation and I hope that people will go back and look because the people in the media who made those terrible predictions about the December surprise and all the bad things that were going to happen apparently forgot that they had made them because they have never revisited them to tell us which ones were accurate and which ones weren't. I think that is a very important part of it.

The S&L crisis was a terrible crisis but, as Mr. Newman said, it had a lot of very unique factors. There were a lot of misjudgments, and so forth. But, for a while there, the S&L crisis came to play in our financial regulatory matters the role of the fall of the

Roman Empire and other matters of public policy. Every time you tried to do something, people would tell you that that is what caused the fall of the Roman Empire and you'd better not do it.

The notion that any effort to change regulation, to expand the scope of the free market, to allow more competition is inevitably going to bring disaster is one of the things that we dealt with and I do think it is very important to go back and look at those predictions that were made about 1992.

Having said that, let me ask one question though and that is there are a couple of problems that people talk about who are opposed to what you are doing and I am generally in favor of it and think you are very much in the right direction here. One is the consumer is being misled and I think the banks have made a mistake because they were not strict enough and in fact some banks were quite culpable with regard, for instance, to the sale of mutual funds. Another is the antitrust tie-in things and those can be dealt with.

But the third and, to me, the most serious is the possible implications for the public treasury if in fact this will lead to more risk of depository institutions. So therefore I want to raise one issue where the Bush Administration I believe asked this Congress to make some changes and we refused to do it and I thought the Administration was right.

What about revisiting the whole question of deposit insurance because one of the things that I think has become clear to us is that the limitation people think is there on deposit insurance is much less of a limit than in fact is there by the time you start redoing things. What about at the same time trying to get more reasonable limits on deposit insurance to limit the risks to the Federal Government.

Mr. RUBIN. You are talking about lower limits per——

Mr. FRANK. Well, lower limits or real limits so that you can't have them in different names or in different ways. I mean, I forget the calculation but what we were told is that one individual could get way over the $100,000, particularly a couple. There were loopholes, even if the $100,000 was really $100,000 per person, it would mean a substantial reduction of risk. I think that would be a way to alleviate what seems to be the most serious fear that people might raise about this.

Mr. RUBIN. Mr. Frank, it is a subject that we have mentioned, but we have not really focused on it. My instinct is to think that we ought to stick with the system that we have but, Mr. Newman?

Mr. NEWMAN. Secretary Rubin.

Mr. RUBIN. You will hear our deliberations in front of your committee.

Mr. NEWMAN. As you mentioned, Mr. Frank, we have addressed that issue sort of indirectly before, and the question that you raise about how much of a pyramid, in a sense, could somebody build with all of the various ways that you can use deposit insurance is a very legitimate question, and why don't we take a look at it again.

I should mention that we have had some conversations with the FDIC about ways of looking at risk in new ways. As you know,

they have a matrix of different fees, different premiums for different degrees of risk, but there may be better ways to identify——

Mr. FRANK. Let me say, if I could break in there briefly, my problem with that is to some extent you run into, contrary to what Ms. Roybal-Allard and Ms. Velasquez and Mr. Kennedy were talking about, that is that some of this risk premium stuff seems to me to work counter to what we are trying to do in the credit extension and therefore I would really rather focus on the question of limiting deposit insurance because I worry that in the nature of penalizing risk taking, you are going to give people an excuse to back away from some of the things we are worried about in the credit extension field.

Mr. NEWMAN. Fair enough. We will take a look at that and see if we can come back to you with that.

I would like to just reinforce the point you mentioned before about the fall of the Roman Empire. There is this risk, and I think this committee is very aware of it, that if we take too short term and narrow a view about protection, even though safety and soundness is extraordinarily important, we can find out that over the long term we will destroy the viability of our banking system. It is almost as if you envision the computer business being required to stay with vacuum tubes and not allowed to go to chips, where would we have been at this point in time?

And if the nature, as the Secretary mentioned earlier, of the financial markets is changing, and they are changing all across the world, we need to adapt or we will not have a viable and safe and sound industry.

Chairman LEACH. Thank you.

We have three more Members, all on the Minority side. Several have been here longer than others. Unless there is an objection, I thought I would go to Mrs. Maloney, Mr. Bentsen, Mr. Kanjorski. If you prefer the other way, I will reverse it. Is there any objection to that approach?

Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman. I apologize for having to go to another meeting and I hope I won't be asking a question that has already been covered.

As I mentioned earlier, I was very concerned with the Chairman of the Federal Reserve's comments yesterday that firewalls "melt in a crisis," which is particularly the time that you need them and he professed ignorance about how there could be a conflict between the interest of a bank in making sound loans and the pressures of the holding company to force the bank to make loans to its securities or insurance affiliate to bail these affiliates out from poor investments which was the original reason for Glass-Steagall.

So if there is a lot of doubt that firewalls will work in times of crisis, then how do you expect them to work in normal times and how do regulations work? We just saw yesterday in Barings, the regulators didn't find this problem, the bank president didn't find this problem and all of a sudden you have a financial crisis in a great banking institution with a great reputation.

How do you expect to enforce these firewalls to protect deposit insurance and to protect the public and to really protect the institution itself.

Mr. RUBIN. I think, Mrs. Maloney, that the answer—and it is obviously a very important question and it really does go to the heart of whether this whole approach is going to work or not work, whether you have a holding company structure or a subsidiary structure—I think it is independent, at least in my view, of the structure.

I think that the answer is like pretty much everything else in our regulated financial service industries, and that is that you have to have the right regulations and then you have to have very serious sanctions for violating the regulations so that when you come up against a crisis——

Mrs. MALONEY. But if the bank fails, what good are the sanctions? I am sure there are types—all kinds of sanctions for Barings for these activities.

Mr. RUBIN. Well, Barings, let's set that aside just for the moment. But if the bank fails for reasons that are inherent to the bank or because of problems that exist within the bank, then the firewalls don't matter because the problem is within the bank itself.

If the bank is sound but it has a nonbank affiliate that fails, that is the moment of pressure and that is the moment when the temptation might be to try to do something to help. At that point if you have appropriately structured firewalls and you have a top management of a bank that knows, if they violate those firewalls, they face very serious penalties, I believe, in some existing law—I think it is correct that there might even be criminal penalties—that tends to be an extremely strong deterrent and I think that is what you are depending on, the judgment you have to make, whether you think a system like that will work or not work. I respectfully would tend to not share the degree of Chairman Greenspan's concern.

Actually, to put my view more strongly, I think if firewalls are properly defined, they are properly constructed, if they are legislated and if they have very strong sanctions for violating them, then top management of firms are not going to want to violate them.

Mrs. MALONEY. I am also concerned about the possible loss of jobs. Last year we passed interstate banking that I totally and completely supported, allowing consolidation. In my district, there has been a consolidation between Chemical Bank and Manufacturers Hanover. And every time I read in the paper there are tremendous layoffs at Chemical. I think they are in trouble. They say, oh, no, we are doing fine, we are just laying people off.

I just got some numbers from the New York Stock Exchange on their member firms. In 1987, they lost 262,000 employees at their member firms. In 1993, 244,000 employees at the same firms. They anticipate a 10 percent reduction in the work force if the present trend continues.

Again, other people have testified that they feel that the jobs will expand but in consolidation, that is not true. I think that is a concern too since I have so many jobs related to the securities industry in the district that I represent.

Mr. RUBIN. Mrs. Maloney, as someone who actually has run one of these firms and has dealt with the question of trying to be com-

petitive in a global context, I think the best chance that our industry has, and I think it has a very good chance of growing and prospering and employing more people, not fewer people, is to be competitive in the global environment and right now it is very competitive.

So I think by making measures that will maintain that competitiveness, you have the highest probability of increasing employment rather than decreasing employment.

Mrs. MALONEY. And from my district, again, there are numerous examples of diversified firms that have failed. Just to give an example, GE Capital and Kidder Peabody, American Express, Shearson Leahman, Sears, All State, Dean Witter, Discovery. All of whom tried to diversify into these new areas which we are trying to encourage with this legislation, yet it did not appear to be a successful one. I would like your comment on that.

Mr. RUBIN. We have also thought about that and it is a very good point. That, I think, is why it is very important that we have strong and legislated firewalls, that we have sanctions so that the firewalls are adhered to and with the various other safeguards, because firewalls are not the whole answer, the various other kinds of safeguards that we propose in our approach.

Mrs. MALONEY. Thank you very much. My time is up.

Thank you, Mr. Chairman.

Chairman LEACH. First, Mr. Ehrlich, did you——

Mr. EHRLICH. No questions, thank you.

Chairman LEACH. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman, Secretaries.

One of the good things about being near the last is most of the good questions get asked before you come up so you don't have to worry about it.

Reading through your testimony, I had a couple of questions and I wanted to ask one question related to your two-way street scenario and how that works where you talked about merchant banking activities of a new consolidated banking company under your proposal.

You say that the merchant banking arm, if you will, could hold a diversified portfolio, up to 5 percent, of a nonfinancial company in relation to its merchant banking activities and I guess my question is, would that say one of these new banks that has a securities affiliate and a merchant banking affiliate be able to, in the process of a leveraged buyout, for instance, be able to hold—to buy a certain percentage, up to 5 percent of their consolidated assets of this company and at the same time would the banking end be able to lend—or would the securities be able to lend to the transaction or would the securities end be able to issue debt for the leveraged buyout?

I realize in the safeguard section, it is clear that a bank and its securities affiliate cannot act in concert in terms of underwriting or guaranteeing securities but, in this case, could they act in concert?

Mr. RUBIN. If the question is, to start with, could the securities affiliate engage in a leveraged buyout as long as the aggregate amount of money involved didn't exceed the 5 percent capital, the answer to that question would be yes.

Mr. BENTSEN. Right.

Mr. RUBIN. If the question is, could the lending function and, say, the equity function work together to try to accomplish the overall leveraged buyout, the answer to that would tentatively be yes in the sense that we suggested before; we felt that in order to get the benefit of the synergies, the two entities should be able to work together.

Now if the question is, could the bank lend at the same time as— is your question then could the bank lend——

Mr. BENTSEN. Well, actually, you have answered my question, and it may be also that——

Mr. RUBIN. Well, there is another question embedded in that, I think.

Mr. BENTSEN. Could the bank lend—could the securities affiliate underwrite the debt, you know——

Mr. RUBIN. I think, as I said in my testimony, it is our judgment—and it is exactly good questions like that that made the reason for the comment in the testimony—we need a strong legislative firewall, we need to work with you all and work these issues out. I think there would be a real question whether the bank should be able to lend to the securities affiliate for that purpose.

Mr. BENTSEN. Well, or not lending to the securities affiliate, but say you're acquiring XYZ Corporation, and the merchant banking buys, you know, a certain percentage of the stock in the public market, the securities affiliate goes out and floats, you know, 10-year bonds as part of the buyout, and the bank provides the bridge loan portion, or the long-term financing portion. Could all three of those work together?

Mr. RUBIN. With the bridge loan to the securities affiliate?

Mr. BENTSEN. No, to the—well, no, to the entity that is actually——

Mr. RUBIN. To the buyout entity, whatever that may be.

Mr. BENTSEN. Buyout entity.

Mr. RUBIN. I think that that is the kind of issue that we need to look at very closely. I have a tentative view, but I will let Mr. Newman express his view first, and then I will decide whether to express my view.

Mr. NEWMAN. Well, let me say right away that I would agree with Secretary Rubin, we need to delve in more carefully. But we can draw from a lot that already exists, because right now bank holding companies can have venture capital subsidiaries, and do. They are separate and there are protections to protect the bank already, but venture capital subsidiaries, in some cases billions of dollars in size, exist today within bank holding company structures, and there are rules for the degree of involvement that both the bank and the venture capital subsidiary can have at any one point in time.

Similarly, in securities firms today, there are merchant banking activities, and there are rules that govern the degree to which a securities firm can be underwriting securities and investing through its merchant banking affiliate simultaneously. So there is a lot we can draw from, and in any case, the structure would protect the insured depository institution. It would be subject to the tie-in re-

strictions that the Secretary mentioned earlier, and subject to securities law.

Mr. BENTSEN. OK. It is an interesting question, I think, and when you look at some of the leveraged buyout transactions that have gone on in the past and some where the securities firms were providing bridge loans—and there are a couple that I can think of where the deals didn't work out as planned, and it did have an impact on their financial viability.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Bentsen. Those are thoughtful inquiries.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

For the record, I would like to compliment the Chairman and his opening remarks. I think they were excellent. We ought to follow that approach.

Mr. Secretary, following on something that my colleague Mr. Frank talked about earlier, those of us that are on the committee that represent districts that I would classify as in the secondary market—and when I say that, I don't mean the secondary market in the securities field, but areas like rural areas of Pennsylvania as opposed to the major markets of Philadelphia and Pittsburgh. The experience that we have recently had with interstate banking, for instance, is that there is an unwillingness to make major credit available in these secondary markets; in some instances because Moody doesn't rate the securities, there isn't a methodology out there to determine whether the investment is good, and the appetite of the primary markets is so great that funds in the secondary market tend to be deposits going into the major banks, and the lending activity seems to be in the major city areas.

Now I don't know how we solve this. I think that presently as we are looking at this, it is going to help our position in international competition, and that is healthy for the country as a whole. I think it is going to stimulate and lessen the difficulties and the need for acquisition and takeouts and buyouts on the national market, and that will be healthy for the economy.

My problem is, how much attention have we paid to some of these lesser developed secondary markets. Now I want to leave you with an example. I was not here, but I would have supported deregulation of the airlines, because in all sense it made sense. And yet now when we look back about 12 years—I want to give you an example. When I fly from Washington to my home district in Wilkes-Barre, it costs me $560. I can fly to Frankfurt, Germany cheaper. I don't care how it affects me because it really doesn't matter for me, but we just cannot attract industries that have executives and technicians that have to move around the world. Their tendency is to move 100 miles south and locate in Philadelphia, where they can make the same round trip for a third or a fourth of the cost.

Applying that type of analogy of what deregulation did to heighten the use of transportation, make it far more efficient in the primary markets, it has almost destroyed the secondary markets of the country.

I look at this piece of legislation, and I realize it will help half, two-thirds of the American domestic market, but I look at it as a great risk as what we are going to do to the secondary markets. And the insurance premium could be a major player in this. If we allow the community banks to acquire multi-account insurance and maintain that—I think Mr. Baker has some ideas along this line that I tend to agree with—and, on the other hand, those institutions that want to deal in more speculative, more sophisticated economic activity, that they do it at the sufferance of losing the broker accounts and the multi-accounts.

It may be something we could look at.

The only other thing that I would suggest, that we have to send the message out to the huge banking institutions that are now coming into secondary markets, that they have to be responsive to the secondary markets. Because for them to locate and buy community banks and other regional banks, come into the market and become just a vacuum cleaner for deposits and not making the capital venture or credit available to small- and medium-sized business that only exists in these rural or secondary markets is very difficult.

My question is, have you and do you feel you have adequately addressed this in this legislation, or is this what you intend to take up, and can we work together on this?

Mr. RUBIN. We would love to work together on it. I think to some extent we have talked about it. In a sense your comment has suggested what may be part of the answer. I agree with you, I think Mr. Baker's comments go in the same direction, so did Mr. Roth's and he is not here now. I think it is very difficult to predict how this is going to affect the kinds of institutions you are talking about, but I think at least one possibility is that you will have entrepreneurial institutions that find there is a very large market niche, which are the kinds of communities you are talking about, and that they can make them profitable in a world where they can offer multiple products, including insurance, brokerage, mutual funds, and various other things. So it is worth putting in place the capability for relatively small communities in ways it is not worthwhile doing today, and that, I think, offers the hope, at least, of a whole new type of financial service, including banking, available in those communities.

Mr. KANJORSKI. The only other thing I want to caution you, as we study the financial and economic advantage of this policy, that we take into consideration the social ramifications of the policy. In an area such as mine, and many of the districts represented, the leadership of our community comes out of the small banker, the insurance broker, the real estate broker, the small stockbroker that is in the area, and as these large companies come in, their answer generally to us when we go to them for the Boy Scouts or the United Fund is, well, we give at the main office. And generally that is New York. That is not rural Pennsylvania, or other areas of the country.

Worse than that, however, is that we are losing our community leadership pool. There is a disconnect, because as large companies come in with their type of leadership, it is a short bent until they move on to corporate growth and so what I get is the 3- to 5-year

executive that comes in and plays a role in a smaller bank, and doesn't become part of the community, and as a result, doesn't put roots in and take leadership roles in the community, so that there is a great negative social impact on leadership in secondary market areas of the country. It is somewhat disturbing that it is affecting what we call as our, quote, advantage quality of life.

We may be formulating economic and financial policies that are beneficial on a large national scope or international scope, and literally be destroying what some of my friends on the other side of the aisle would like to remake America into being, and that is, you know, quality America, and some of us have that in our districts now. So I would like that to be considered.

Mr. RUBIN. That is a very thoughtful comment, and we will so do.

Mr. NEWMAN. Mr. Chairman, may I just add to that? Just following up on Secretary Rubin's comments earlier, one of the things we have talked about specifically is can this mechanism help provide equity financing, subordinated debt, other kinds of financing for medium-sized growing companies that don't happen to be located in the major cities?

Right now the Wall Street firms can serve New York and Chicago and Los Angeles very well, but it is very difficult for them to economically serve all the areas of the country where there are small, medium-sized growing companies. And if this mechanism would provide a means for, in addition to lending by small banks, for small banks—local banks, community banks—to provide mechanisms, whether it be on their own or through the kind of affiliation that Secretary Rubin mentioned earlier with a larger firm, to bring to bear in the individual communities the kind of financing that is necessary for these companies to grow, we will have accomplished a great deal.

Mr. KANJORSKI. Could I just respond to that? It almost is some sort of an extension of theory of CRAs, but I have never supported the total concept of CRAs. I think they should be used in a very targeted way, and they are very healthy. But if this goes into place with that vacuum cleaner effect, we may find ourselves having to come back here some day and saying, gee, we are going to have to find a way to disburse these funds, and get into that whole CRA argument again.

Chairman LEACH. Well, I thank the gentleman for his very thoughtful set of concerns.

Let me just return very briefly, if I could. I don't mean to extend the hearing, but the reason I am concerned about these activities being in the bank itself instead of in a holding company structure is that you take pressure off capitalization, and I think it is insufficient to say only a well-capitalized bank can be involved, because suddenly you end up intermixing your capital. And so I think a bank is going to require more capital to do these activities that they are separately segregated, and clearly so; otherwise, inevitably, you almost get into a double accounting on capital circumstance.

Now you can avoid that stringently in one or two areas, but suddenly banks take on multiplicity of activities, and it is not an easy thing to cut through, for me to see how you can do that.

Second, you clearly spread the deposit insurance safety net if you put these things within the bank's structure.

Third, I would stress to everybody that there are competitive concerns, symbolized by the concerns raised by the gentleman from Pennsylvania, and to the degree that there is an understanding both in a regulatory conceptualization circumstance, as well as in a competitive circumstance, that these activities are outside the structure of a bank and so that there is less real or perceived coercion, the better. And that is one of the reasons that I favor taking it out.

But in this regard, one of the warning signs of the week literally is the Barings circumstance, and it appears here that what in effect is a merchant or an investment banking function within the constraints of a bank caused a difficulty to presumably a British governmental safety net, and we can make analogies to the United States. How do you respond to that, Mr. Secretary? Doesn't Barings drive a stake into the heart of the argument that these functions ought to be within a bank structure, or do you think it is irrelevant?

Mr. RUBIN. I don't think that it affects structure in the sense that—at least it is our view, and as I said at the very beginning, I think that is something we really need to explore further—in terms of safety and soundness, that if you have appropriate procedures, firewalls, and all of the rest, that the question of structure, holding company vs. subsidiary, should not make any difference. But that is our view. You obviously hold a somewhat different view, and I think that is what we need to explore as we go forward, though it is our view that whatever issues Barings may raise about this whole venture, I don't think it raises any more of an issue with the subsidiary structure than with the holding company structure.

Chairman LEACH. Yes. There also is a possibility, and let me just throw this out——

Mr. RUBIN. It isn't just a question of nomenclature, but you referred to doing it within the bank. Of course, we don't advocate it. We advocate that it be done in the subsidiary.

Chairman LEACH. One of the other minor things, and I don't know if this is going to be serious or not, but historically because of functional regulation, the committee of jurisdiction, the Commerce Committee, has always wanted this in a holding company format. They feel that the SEC can examine functionally better. Also if you put it within a subsidiary, you raise some prospects of what we have come to call regulatory arbitrage. That is, banks will choose the regulator which is the easiest to authorize new functions or supervise with the least requirements for capital or whatever. And I just raise that as a concern as well in this regard.

Anyway,——

Mr. RUBIN. Well, the other side of that, I suppose, is that as long as you have regulators that are committed to safety and soundness, there is perhaps something to be said for having more than one regulator on the more general theory that if you only have one of anything, it has a monopoly and that in itself can tend to create its own problems.

Chairman LEACH. That is a valid argument, too, and I want to come back to that in one other way in just a second.

I want to turn to Mr. Baker, if he had any——

Mr. BAKER. No questions, thank you.

Chairman LEACH. OK. Let me come back to that.

H.R. 18 puts the authority to define what are new activities in the Federal Reserve Board. Your approach, which you have suggested, takes a seven-member council, which includes the Federal Reserve Board. It ends up those conclusions are of extraordinary significance for the future, and rather than simply stating what your approach is, I would be appreciate if you could give the arguments for your approach, and also I would like to inquire whether there can be in-between approaches. I mean you have a seven-member structure; there could be a three-member structure. For example, Treasury, Fed, the SEC.

But, anyway, I would like to have you give the rationalization why you prefer your approach to the Fed approach.

Mr. RUBIN. I think you are raising a very fundamental, philosophical question. It is our view that it is appropriate, and we are fully supportive of the Treasury not being prohibited from being involved in specific transactions, whether enforcement or whatever it may, and as you know, that is the law of the land, and we are totally supportive of it.

It is our view, though, that when you get to the policy issues, that policy issues ultimately should be resolved by elected officials and their appointees, and in this instance, the question of what is a financial company is really a policy issue, and the notion or the idea of having this kind of a vehicle would bring together the various interested regulators into a context in which those who are ultimately accountable to the electorate would be involved. As I say, we distinguish between policy, where we think those who are accountable to the electorate should be involved, and the whole enforcement function, and more broadly, dealing with specific matters where we think that it is appropriate to prohibit that involvement. But in between, we are not wedded to this particular apparatus.

Mr. NEWMAN. If I might add, along the lines that Secretary Rubin just mentioned, there clearly is nothing magic about the composition. The thinking was very straightforward. It was just to take those regulators, as the Secretary just mentioned, who are actively involved in regulating institutions that are in question. We would include the Fed because they are actively involved; so are the OCC and the OTS, and the FDIC has a role.

In addition, since the SEC under these proposals, under the functional regulation proposal, would be the regulator of the securities business, regardless of where it was in the corporate structure, they may have a lot to add to the discussion.

And similarly, as the nature of financial instruments changes, futures transactions may be becoming increasingly important. As a matter of fact, they were actually what was involved in Barings Brothers this week, and the CFTC may have substantive additions.

As you know, the Working Group on Financial Markets, which is chaired by Secretary Rubin, includes the Fed, the SEC, and the CFTC. It was just that kind of thinking, but there is nothing magic to it.

Mr. BAKER. Mr. Chairman?

Chairman LEACH. Yes, Mr. Baker.

Mr. BAKER. On that particular point, the Commission described by Treasury today is a commission similar to the one envisioned in my own proposal, but it has a slightly different reason for being there, and I just want to interject that into the mix as well, since the role would not be under our legislative direction to define financial interest, it is rather to help in the regulatory exchange because as you, I think rightfully, point out, the SEC, for example, may be particularly attuned to a derivatives issue that may not yet be in your radar screen.

And so I think no matter what mode we finally wind up adopting, that that interregulatory conference is very valuable in addressing a very rapidly changing market, and so I support it, whether it is three or five or seven, Mr. Chairman, but I think we certainly should have a council that enables the regulators to respond as timely as is possible, without regard to the other issue of whether financial interests do in fact need to be defined.

Thank you, Mr. Chairman.

Chairman LEACH. Well, I don't want to drag this on, but there is a very profound ancillary issue that relates to Mr. Baker's concerns, which is in the derivatives arena. We have a bill on the subject of which the centerpoint is an interagency council, that among things has authority to look at derivatives as functional instruments rather than by the category of institution that deals in these instruments, and that at the moment, without a legislative approach, for example, the insurance industry is outside the scope of Treasury/SEC guidelines in many respects, and it is quite conceivable that it is in the context of this bill that that issue ought to be dealt with.

But I would like to get a response of the Treasury in that regard. Does that make sense, or——

Mr. RUBIN. Yes, I think, Mr. Chairman, the financial markets working group has not been established by statute, but it does function. The Secretary of the Treasury is the chair of it. It actually is quite an effective mechanism for dealing with these kinds of issues, and in the world that we live in today, clearly these issues cross industries as they cross regulators.

Insurance, as you correctly say, is not a part of that effort, for the reasons that you say. So I think that if, when we finish all this, we in some way institutionalize what is now the financial markets working group, I think that could be a constructive development, and I think if insurance got brought in under it in appropriate respects—and there are all sorts of issues here about State regulation versus Federal regulation—but if it got brought into it in appropriate respects, I think that is a very important step forward.

Chairman LEACH. OK. If there are no more comments, let me thank the two of you for a very helpful discourse on a wide ranging number of subjects.

Mr. RUBIN. Thank you.

Chairman LEACH. The committee is adjourned.

[Whereupon, at 1:01 p.m., the hearing was adjourned.]

APPENDIX

February 28, 1995

HONORABLE JAMES A. LEACH
CHAIRMAN, HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES

OPENING STATEMENT
HEARINGS ON THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995
FEBRUARY 28, 1995

Today the Committee begins hearings on legislation to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers.

For the past 60 years, federal law has restricted affiliations between banks and securities firms. While these restrictions contained in the 1933 Glass-Steagall Act made some sense at the time that Act was passed, they are not appropriate for today's financial world. It is simply unrealistic for commercial banks to be precluded from offering financial products of customer choice. It is also unrealistic to legislatively maintain constraints on market competitiveness for securities firms, as well as for banks.

In recognition of the need to modernize U.S. banking laws to reflect the rapidly changing financial services marketplace, the Committee on Banking and Financial Services begins its consideration today of the "Financial Services Competitiveness Act of 1995" which I originally introduced on January 4th and which has been revised and was reintroduced yesterday. The legislation is "win-win" legislation for the banking and securities industry. It looks to the future financial marketplace by dramatically expanding the ability of banking organizations to engage in securities activities and other "financial" activities. At the same time, it establishes a two-way street that permits securities firms to be

equal partners of banks, not subsidiaries of banks, by permitting securities firms to acquire banks. While expanding the scope of activities, it also recognizes the dynamic nature of the financial services marketplace, by reducing unnecessary, anti-competitive, micromanaging regulatory burdens that have been previously associated with these activities--all the while preserving safety and soundness.

Under the bill, the Bank Holding Company Act would be recast as the Financial Services Holding Company Act and bank holding companies would be redesignated as financial services holding companies to recognize the changing financial services marketplace. Companies could choose between two structures for the affiliation of banking and securities firms. Companies with any insured depository institution affiliates would become financial services holding companies. Companies without any insured depository institution affiliates may become investment bank holding companies. An investment bank holding company would be any financial services holding company that controls an uninsured wholesale financial institution and a securities affiliate. Financial services holding companies with insured depository institution affiliates would have higher firewalls due to federal deposit insurance.

Highlights of the proposed Financial Services Competitiveness Act include the following:

1.) Expanding the scope of permissible activities for bank affiliates by providing that the activities must be "financial in nature" rather than "closely related to banking."

2.) Permitting bank affiliation with companies engaged in all securities activities, including underwriting corporate debt, equity, and mutual fund shares.

3.) Repealing Section 20 of the Glass-Steagall Act.

4.) Expanding the ability of banks to serve small communities by authorizing banks to underwrite municipal revenue bonds directly.

5.) Eliminating several anti-competitive or micromanaging "firewalls" currently imposed by the Federal Reserve under Section 20; retaining only those firewalls that are necessary for safety and soundness.

6.) Permitting the Federal Reserve to maintain general discretion to modify any firewall as necessary, thus preserving critical regulatory flexibility.

7.) Streamlining the authorization process for non-banking activities

8.) Allowing securities firms to be equal partners in affiliations with banks by allowing the firms to acquire either insured banks or uninsured wholesale financial institutions.

9.) Adopting a system of functional regulation to ensure that participants in the securities business operate under the same rules, with the SEC being the primary regulator of participants in the securities markets.

There are broad philosophical issues as stake in this upcoming debate. The Financial Services Competitiveness Act eliminates many distinctions between commercial and investment banking, but it does not break down the barriers between banking and commerce.

With regard to the issue of merging commerce and banking, care should be taken to recognize that not only do many in American commerce object, such as the vast majority of community bankers and independent insurance agents, but there also is no broad public support for such a philosophical departure. Indeed, there aren't 500 people in America who advocate this approach, half of whom

represent foreign institutions and the other half several dozen large American companies.

Ours has always been a nation with grave doubts about the concentration of financial power and a preference for the decentralized delivery of financial services. Ours is also a nation that historically has not approved of the idea of commercial enterprises controlling banks and vice-versa. This is, after all, the country of Thomas Jefferson and Andrew Jackson; a country of individualism rather than collectivism.

As well-known Wall Street guru Henry Kaufman noted in Congressional testimony about the subject several years ago:

> "I believe it ultimately puts in jeopardy the fundamental economic democracy of this country and undermines the crucial need for independent depository institutions exercising objective credit judgments...I emphasize that a merger of banking and commerce would tend to produce an undesirable concentration of economic and financing power, while providing no significant compensating benefits."

It is true that Germany and Japan allow certain ties between banking and commerce, but interestingly, based on an aroused public, the Bundestag is currently considering legislation to make German laws more similar to our own. As for Japan, there are few Americans who have kind things to say about their conflict-ridden system. Whether or not it fits Japan or any other country, interlocking directorships with cross ownership of banks and industrial companies are largely alien to the American free enterprise culture.

Finally, I would like to stress that I have grave concerns about one aspect of the new Treasury approach unveiled yesterday.

The Administration is suggesting that expanded bank powers be permitted in the operating subsidiaries of banks. I believe that such an approach, which is contrary to existing law, is imprudent. Allowing a bank or its subsidiary to engage in risky non-banking activities would jeopardize the deposit insurance system. The Treasury proposal would grant federally insured institutions direct investment authority for non-banking activities analogous to the direct investment authority that S&Ls garnered in certain states in the 1980s.

Indeed, the news of the week -- the failure of Barings, one of Britain's oldest financial institutions -- demonstrates the problematic nature of conducting activities in a bank subsidiary and shows how quickly an operating subsidiary can bring down a parent.

So there is no misunderstanding, while I am pleased the Treasury has come out foursquare for Glass-Steagall reform, I expect to oppose as fully its efforts to increase liabilities for the deposit insurance system as I will oppose all efforts to merge commerce and banking.

Patently, the Treasury approach appears to be a back door regulatory consolidation plan designed to pander to or push money center banks under the watch of the OCC and the Executive Branch. It is my long-held view that the holding company format provides the greatest insulation for insured depository institutions and the greatest protection for taxpayers. It is also my long-held view that to the maximum extent possible regulation should be outside of

politics and this is one of the reasons I favor the Fed as the key regulator.

Members of this committee understand the financial services reform we are contemplating is of historical significance. Involved are large philosophical questions as well as numerous nuances, with extraordinary ramifications for the financial industry. In developing this bill over the past year, which will serve as the principal mark-up vehicle, let me stress that we have carefully attempted to balance as many perspectives in as consistent way as possible, and I am pleased to announce both Goldman Sachs and J.P. Morgan have endorsed the legislation.

I would like to thank Chairman Greenspan and today's other witnesses for joining us today and I look forward to their testimony.

STATEMENT FOR CONGRESSMAN FLOYD H. FLAKE
BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES
FEBRUARY 28, 1995

GOOD MORNING MR. CHAIRMAN, MEMBERS OF THE COMMITTEE AND OUR DISTINGUISHED WITNESSES. MR. CHAIRMAN, AS WE ADDRESS THE ISSUE OF BANK MODERNIZATION, SPECIFICALLY AS IT RELATES TO THE POTENTIAL REPEAL OF THE GLASS-STEAGALL ACT THAT SEPARATES COMMERCIAL BANKING AND SECURITIES-UNDERWRITING, AN ISSUE WHICH HAS GENERATED CONTROVERSY AND CONCERN OF MILLIONS OF AMERICANS. IT IS CLEARLY TIME THAT WE CONFRONT BANK MODERNIZATION AND THE MANY ISSUES THAT EXPANDING BANKING POWERS WILL ENCOMPASS.

WHILE I AM CONCERNED ABOUT THE NEGATIVE IMPACT ON THE BANKING AND FINANCIAL SERVICES INDUSTRIES AS A RESULT OF INACTION ON THE QUESTION OF ENLARGING BANKING POWERS, I WOULD BE EQUALLY AS TROUBLED IF WE OVERLOOKED THE FACT THAT THE GLASS-STEAGALL ACT REFLECTED A JUDGMENT THAT THE COMMINGLING OF COMMERCIAL LENDING AND SECURITIES UNDERWRITING PRESENTED TEMPTATIONS AND CONFLICTS OF INTEREST THAT THREATENED THE CREDIBILITY AND SOUNDNESS OF THE FINANCIAL SYSTEM.

MOREOVER, IF WE DECIDE THAT THE ENLARGEMENT OF BANK POWERS WILL BE BENEFICIAL TO THE BANKING SYSTEM, WE MUST BALANCE THESE ENHANCED POWERS WITH REAL RESTRICTIONS THAT ENSURE THAT INCREASED

BANKING POWERS DO NOT JEOPARDIZED THE LEGITIMATE EXPECTATIONS OF DEPOSITORS, THE DEPOSIT-INSURANCE GUARANTEE BACKED BY TAXPAYERS, OR THE FREEDOM OF CHOICE OF COMMERCIAL CUSTOMERS THEREFORE, WHEN CONSIDERING BANKING REFORM, WE MUST ENSURE THE TWIN GOALS OF IMPROVING EFFICIENCY AND LIQUIDITY WHILE ALSO PROTECTING DEPOSITORS, TAXPAYERS, AND BORROWERS.

I BELIEVE THAT WE HAVE ONE OF THE MOST COMPETITIVE BANKING AND FINANCIAL SERVICES INDUSTRY THE WORLD OVER, NOTWITHSTANDING THE LEGAL BARRIERS OF THE DEPRESSION-ERA GLASS-STEAGALL ACT. AGAIN, I BELIEVE WHATEVER REFORM APPROACH WE CONSIDER WE MUST NOT OVERLOOK THE INTENT OF GLASS-STEAGALL. HOWEVER, THE FINANCIAL SERVICES INDUSTRY HAS CHANGED; THEREFORE, OUR BANKING LAWS SHOULD REFLECT THESE CHANGES. I DO NOT BELIEVE WE SHOULD SUPPORT ANY LEGISLATION, OLD OR NEW, THAT IMPEDES THE COMPETITIVENESS OF OUR FINANCIAL INDUSTRY PARTICULARLY GIVEN THE GLOBAL ARENA THAT WE FIND OURSELVES IN TODAY.

THESE HEARINGS, I AM CERTAIN, WILL PROVE TO EDUCATE OUR COMMITTEE AS WELL AS THE AMERICAN PEOPLE REGARDING BANK RESTRUCTURING AND ITS IMPLICATIONS. I LOOK FORWARD TO THE TESTIMONY OF THESE WITNESSES AND MOVING FORWARD IN PRUDENT MODERNIZATION OF FINANCIAL SERVICES.

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OPENING STATEMENT

Committee on Banking and Financial Services

"Hearing on HR 18, Glass Steagall Reform
and related Issues"

February 28, 1995

Thank you Mr. Chairman. Today's hearing is the first step in a long, yet accelerated, process, that will most likely result in dramatic reform of the laws governing our nation's financial services sector.

There is common agreement that the laws that govern financial services -- such as Glass-Steagall and the Bank Holding Company Act -- must be updated to reflect the realities of today's financial markets.

When I was growing up, most people would have no difficulty in describing the difference between a bank and a securities firm, or an insurance company and car manufacturer.

But those days of neat compartmentalization are long past.

Few statistics are as illustrative of the blurring of those compartments than the rapid decline of the market share (defined as net new lending) held by US commercial banks.

In 1982, commercial banks accounted for more than 20% of new lending; in 1993, that share had declined to about 15% and had dipped as low as 7%.

The market share of lending held by securities and finance companies was barely 12% in 1982; in 1993, that share was almost 30% -- more than twice the share held by commercial banks.

By the same token, banks have moved into areas previously dominated by securities firms: JP Morgan, for example, is now one of the nation's ten largest underwriters of corporate debt; Bankers Trust is also in the top ten.

General Electric and General Motors are both owners of enormous commercial lending firms. And, of course, who can accurately put a label on a company like American Express, Primerica, Dean Witter Discover or the Travellers?

It's clear from market realities, from changes made by the Federal Reserve to the Bank Holding Act, from the Supreme Court's recent VALICO ruling that Congress, in modernizing financial laws, is not itself legislating these changes, but is in fact responding to the complete transformation of the financial landscape.

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Hon. Carolyn Maloney/February 27, 1995
page 2 of 2

This Committee will consider a number of ways to modernize our banking laws, from subtle and modest changes to dramatic reforms.

There is much to be said for both approaches, but I believe that such reform must be guided by a few fundamental principles:

> ONE: Any legislation must continue to ensure the safety and soundness of the Federal deposit insurance system.
>
> TWO: Any legislation must create a level playing field for all the industries affected by financial services reform.
>
> THREE: Any legislation must be beneficial to the American consumer and must also enhance the ability of US firms to compete in the global marketplace.
>
> FOUR: Any legislation must be structured in such a way as to ensure vigorous oversight of all the activities of a financial services firm by the appropriate regulators. In other words, it makes no sense to have bank examiners suddenly attempting to evaluate matters previously regulated by the SEC or the CFTC suddenly trying to learn about insurance regulation. The expertise of the various individual regulatory agencies must be preserved in some way.
>
> FIVE: The legislation must guard against the over-concentration of capital in the hands of a few diversified corporations. As the sudden collapse of Britain's Barings investment bank demonstrates, any single financial institution can be demolished within a short period of time. Concentration of capital in too few corporations could easily lead to making the US economy as a whole more susceptible to the kind of economic shocks that currently afflict only a single corporation.

If this Committee adheres to the principles that I've outlined, I believe that modernization of our financial laws will result in more profitable and competitive US companies, and will also benefit consumers by making more products available at lower cost.

We all agree on the goal Mr. Chairman, but it will be easy to be diverted as we proceed on the path to that goal.

I am looking forward to the hearings today and tomorrow, and many more such hearings as we proceed later this spring to a mark-up of this landmark reform.

Thank you.

HEARING ON GLASS-STEAGALL REFORM
Statement of Maxine Waters

Mr. Chairman, I appreciate your calling this set of hearings on bank power reforms. Those of us who have served on this panel remember the last time Congress set about trying to fundamentally reform our bank laws. At that time, one of the most pivotal discussion was the subject of today's hearing -- reform of the so-called Glass-Steagall Act.

It is important to keep our financial service sector competitive and up-to-date. Obviously, this is a rapidly changing international industry. We all have an interest in making sure that domestic banks are able to keep up with their international competition.

However, I have two basic concerns as we enter this debate. First, the United States has long-standing laws which deliberately set apart banks from other commercial businesses. These laws are in place for very good reasons. While circumstances of the marketplace have certainly changed since the adoption of Glass-Steagall, the underlying concepts which led to those laws remain current.

Federal deposit insurance is a cornerstone of U.S. banking policy. However, given the magnitude of the borrowing authority of this insurance, the potential for misuse is massive. The savings and loan scandal is the most recent example of how deposit insurance can lead to dramatic abuse, if adequate safeguards and oversight do not accompany it. Any reform of this law must include appropriate safeguards for consumers if we are to move forward, and not simply give banks new powers under the rubric of reform.

My second concern is more general. This Congress has embarked on a huge program of deregulation and a transfer of power to large corporations -- including those in the financial service sector. I have always maintained that regulatory relief for business are acceptable as long as that relief comes in the context of making sure consumers and low-income communities can share in the benefit.

This balanced is now fundamentally upset. The current Congress' attitude recalls an old adage of the 1950s -- "Whatever is good for business is good for America." My constituents, for one, know this not to be the case. Whether we are in an era of bank regulation or deregulation, my part of the country feels the same results -- redlining, mortgage discrimination and branch closings.

Startlingly, last week the Appropriations Committee eliminated funding for President Clinton's community development bank legislation. That legislation was as important as anything this committee did last session for many of us. It also carried with it a multi-pronged regulatory relief package. The logic then was, we give the banks relief and we'll open up lending opportunities in poor rural and urban communities. Some banks were so satisfied with this tradeoff that they contributed multi-million checks to assist the community development bank effort. Today, this spirit of balance and compromise seems to be lost.

Mr. Chairman, I hope we gain find it within ourselves in this fiercely ideologically charged climate, to work together to make sure what may be good for businesses and investors is truly good for all types of consumers at the same time.

The Honorable Kenneth E. Bentsen, Jr.
before the House Banking and Financial Services Committee
Tuesday, February 28, 1995

Mr. Chairman, Thank you for giving me the opportunity to comment on one of the most important debates for this Congress to address. Today, we begin down the path to restructure the regulatory framework that governs our financial institutions.

Our financial markets and financial services have changed since the 1930s', when the Glass-Steagall Act passed. Gone are the days when consumers simply keep one checking account in the bank on Main Street. Consumers can get capital from many different sources, including banks, credit card companies, insurance companies, and commercial companies. Revolutions in retail and in technology have made the old-fashioned bank model, and with it, the Glass-Steagall Act, obsolete.

Consumers want access to their assets and loans in one location. Mr. Chairman, the days of shopping at the local butcher, baker, and dairy are long gone. Consumers should have the choice of buying services from their local bank or the larger, full-service institution. This competition will benefit consumers, and result in more services at lower prices.

I would argue that, in fact, the marketplace is ahead of Congress. The Federal Reserve continually allows banks to set up securities affiliates under Section 20 waivers. This relaxation of rules will mean that more capital is available to customers. Perhaps more than anything, Congress must act to catch up with the marketplace and establish ground rules for the merger of commercial and investment banking. There will be a need to describe the safeguards that will protect the integrity of the markets and the safety and soundness of our system. I have witnessed how quickly capital can flow in and out of an organization. I have seen billions of dollars of capital disappear in as little as 48 hours. We must ensure that the risk of securities markets is not subsidized by federally insured deposits. I believe we can do that and increase consumers choice through Glass Steagall reform.

These new choices will require more regulatory flexibility. Today's consumers demand and deserve sophisticated financial instruments that will facilitate their financial independence and well-being. Customers are seeking one-stop shopping companies to purchase all of the financial loans, investments, and cash accounts. The current structure of the Glass-Steagall Act is a cumbersome, outdated wall standing between today's consumers and the modern marketplace. We must be willing to meet the marketplace, but ensure integrity, safety and soundness.

I look forward to the testimony that will be offered today.

For release on delivery
10:00 a.m. EST
February 28, 1995

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking and Financial Services

U.S. House of Representatives

February 28, 1995

I am pleased to be here today to present the views of the Board of Governors of the Federal Reserve System on expanding permissible affiliations between banks and other financial services providers. The bills being introduced in this Congress, such as the newly revised "Financial Services Competitiveness Act of 1995," introduced by Chairman Leach, would continue the modernization of our financial system begun with last year's passage of the landmark interstate banking legislation. The Leach bill would authorize the affiliation of banks and securities firms, as well as permit banks to have affiliates engaged in most other financial activities.

Before I present the Board's views, however, I first want to commend Chairman Leach for his leadership in recognizing the importance of congressional action in this area and for acting promptly to bring his bill before the Committee for its consideration. The new Leach bill would reform outdated statutory prohibitions established for a financial system that no longer exists. It thus provides Congress with the opportunity to make the financial system more competitive and more responsive to consumer needs, all within a framework that would maintain the safety and soundness of insured depository institutions. The Board believes that modern global financial markets call for permitting financial organizations to operate over a wider range of activities. The approach contained in the new Leach bill would be a major step. providing realistic reform, and thus has the strong support of the Board of Governors of the Federal Reserve System.

There is, I think, general agreement on the forces shaping our evolving financial system—forces that require that we modernize our statutory framework for financial institutions and markets. The most profound is, of course, technology: the rapid growth of computers and telecommunications. Their spread has lowered the cost and broadened the scope of financial services, making possible new product

development that would have been inconceivable a short time ago, and, in the process, challenging the institutional and market boundaries that in an earlier day seemed so well defined. Technological innovation has accelerated the second major trend, financial globalization, that has been in process for at least three decades. Both developments have expanded cross–border asset holdings, trading, and credit flows and, in response, both securities firms and U.S. and foreign banks have increased their cross–border locations. Foreign offices of U.S. banking organizations have for some time been permitted, within limits, to meet the competitive pressures of the local markets in which they operate by conducting activities not permitted to them at home. In the evolving international environment, these off–shore activities have included global securities underwriting and dealing, through subsidiaries, an activity in which U.S. banking organizations have been among the world leaders, despite limitations on their authority to distribute securities in the United States.

Such a response to competition abroad is an example of the third major trend reshaping financial markets—market innovation—which has been as much a reaction to technological change and globalization as an independent factor. These developments make it virtually impossible to maintain some of the rules and regulations established for a different economic environment. As a result, there is broad agreement that statutes governing the activities of banking organizations increasingly form an inconsistent patchwork.

For example, under federal standards, banking organizations may act as agents in private placements of securities and, in fact, have done so quite successfully, accounting recently for one–third of all corporate bonds and one–seventh of all equity privately placed. Banking organizations may also act as brokers of securities, and as investment advisers for individuals and mutual funds. For many years, they have acted

as major dealers in U.S. government and municipal general obligation bonds. Banking organizations are also the leading innovators and dealers in derivatives, and banking organizations operate futures commission merchants as holding company subsidiaries. As just noted, banking organizations underwrite and deal in securities abroad and, since 1987, banking organizations with the necessary infrastructure may apply for limited underwriting and dealing of securities through special bank holding company subsidiaries under a Federal Reserve Board interpretation of Section 20 of the Glass–Steagall Act.

In a pattern that is reminiscent of interstate branching developments, the states for some time have been removing restrictions on the activities of state chartered banks. The FDIC, as required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA), reviews such activities, but has not rejected an application to exercise any of these powers from adequately or well–capitalized banks. According to the Conference of State Bank Supervisors (CSBS), in 1993, seventeen states—including several large ones—had authorized banks to engage in securities underwriting and dealing, with about half requiring such activity in an affiliate. At the federal level, the OCC has proposed a process to allow national bank subsidiaries to conduct activities not permitted for the bank.

And so it goes on. Technological change, globalization, and regulatory erosion will eventually make it impossible to sustain outdated restrictions, and these forces will be supplemented by piecemeal revisions to federal regulation and sweeping changes in state laws. That is what we are here today to discuss—the need to remove outdated restrictions and to rationalize our system for delivering financial services. I might note that in this regard the United States is behind the rest of the industrial world. Virtually all the other G–10 nations now permit banking organizations to affiliate with

securities firms and with insurance and other financial entities. We are among the last who have not statutorily adjusted our system. That might be acceptable, or even desirable, if there was a good reason to do so. We do not think there is such a reason to retain the status quo.

Let me be clear that the Board's position in favor of expanding the permissible range of affiliations for banking organizations is not a reflection of a concern for banks, their management, or their stockholders. U.S. bank management has been quite creative—indeed has led others—in developing and using both technology and the globalization of financial markets for profitable innovations that have greatly benefitted their customers. Rather, the Board's support for the expansion of permissible activities reflects the desirability of removing outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that, as a result, limit choices and options for the consumer of financial services. Such statutory prohibitions result in higher costs and lower quality services for the public and should be removed. That their removal would permit banking organizations to compete more effectively in their natural markets is an important and desirable by-product, but not the major objective, which ought to be a more efficient financial system providing better services to the public. Removal of such prohibitions moves us closer to such a system.

Indeed, the Board urges that, as you consider the reforms before you, the focus not be on which set of financial institutions should be permitted to take on a new activity, or which would, as a result, get a new competitor. All are doing similar things now and are now in competition with each other, offering similar products. Securities firms have for some time offered checking-like accounts linked to mutual funds, their affiliates routinely extend significant credit directly to businesses, and they are becoming increasingly important in the syndicated loan market. Banking organizations

are already conducting a securities business. While indicative of the need for reform, which institution has leaped some earlier restraint is not the issue. The Board believes that the focus should be: do the proposed bills promote a financial system that makes the maximum contribution to the growth and stability of the U.S. economy? Are existing restraints serving a useful purpose? Do they increase the compatibility of our laws and regulations with the changing technological and global market realities in order to ensure that these goals are achieved? Are they consistent with increased alternatives and convenience for the public at a manageable risk to the bank insurance fund?

Banking organizations are in a particularly good position to provide underwriting and other financial services to investors. They are knowledgeable about the institutional structure of the market and skilled at evaluating risk. Moreover, for centuries, banks' special expertise has been to accumulate borrower–specific information that they can use to make credit judgments that issue–specific lenders and investors cannot make. Overcoming such information asymmetries has been the value added of banking on the credit side. Indeed, it would appear that most companies want to deal with a full–service provider that can handle their entire range of financing needs. This preference for "one–stop shopping" is easy to understand. Starting a new financial relationship is costly for companies and, by extension, for the economy as a whole. It takes considerable time and effort for a company to convey to an outsider a deep understanding of its financial situation. This process, however, can be short–circuited by allowing the company to rely on a single organization for loans, strategic advice, the underwriting of its debt and equity securities, and other financial services. As evidence that there are economies from this sharing of information, most of the Section 20 underwriting has been for companies that had a prior relationship with the banking organization.

Our discussions with Section 20 officials suggest that the economic benefits of "one–stop shopping" are probably greatest for small and medium–sized firms. These firms, as a rule, do not attract the interest of major investment banks. and regional brokerage houses do not provide the full range of financial services these companies require. Rather, their primary financial relationship is with the commercial bank where they borrow and obtain their services. Thus, from the firm's perspective, it makes sense to leverage this relationship when the time comes to access the capital markets for financing. It is thus reasonable to anticipate that if securities activities are authorized for bank affiliates, banking organizations, especially regional and smaller banking organizations, would use their information base to facilitate securities offerings by smaller, regional firms, as well as local municipal revenue bond issues. Many of these banking organizations cannot engage in such activities now because they do not have a sufficient base of eligible securities business revenue to take advantage of the Section 20 option that limits their ineligible revenues to 10 percent of the total. Investment banking services are now available for some of these smaller issues. but at a relatively high cost. Section 20 subsidiaries at regional banks indicate that they are eager to expand their investment banking services to small and moderate–sized companies. These Section 20 subsidiaries view such firms as underserved in the current market environment and see an opportunity to provide a greater range of services at lower prices than those now prevailing.

I should also note that almost all bank holding companies that have set up Section 20 subsidiaries believe that the diversification of revenues will result in lower risks for the organization. While the empirical literature is inconclusive, and the Section 20's themselves have not been around very long, and have operated under significant

restrictions, it seems likely that some bank holding companies could achieve risk reduction through diversification of their financial services.

To be sure, with the benefits comes some risk, but I read the evidence as saying that the risks in securities underwriting and dealing are manageable. Underwriting is a deals oriented, purchase and rapid resale, mark–to–market business in which losses, if any, are quickly cut as the firm moves to the next deal. Since the enactment of the Securities Acts—with their focus on investor protection—the broker/dealer regulator, the SEC, is quick to liquidate a firm with insufficient capital relative to the market value of its assets, constraining the size of any disturbance to the market or affiliates. The SEC now applies such supervision to Section 20 affiliates, and it would do so to securities affiliates under the revised Leach bill and similar bills introduced so far in this Congress. Section 20 affiliates have operated during a period in which sharp swings have occurred in world financial markets, but they still were able to manage their risk exposures well with no measurable risks to their parent or affiliated banks. Indeed, in order to limit the exposure of the safety net, the supervisors have insisted that securities affiliates have risk management and control systems that assure that risk can be managed and contained. As would the case with the new "Competitiveness Act," the Federal Reserve has required that such an infrastructure exist before individual Section 20 affiliates are authorized and that organizations engaging in these activities through nonbank affiliates have bank subsidiaries with strong capital positions.

The Leach bill continues the holding company framework, which we believe is important in order to limit the direct risk of securities activities to banks and the safety net. The Board is of the view that the risks from securities and most other financial activities are manageable using the holding company framework proposed in

that bill. But there is another risk: the risk of transference to nonbank affiliates of the subsidy implicit in the federal safety net—deposit insurance, the discount window, and access to Fedwire—with the attendant moral hazard. The Board believes that the holding company structure creates the best framework for limiting the transference of that subsidy. We recognize that foreign subsidiaries of U.S. banks have managed such activities for years virtually without significant incident. Nonetheless, we have concluded that the further the separation from the bank the better the insulation. We are concerned that conducting these activities without limit in subsidiaries of U.S. banks does not create sufficient distance from the bank. Moreover, even though the risks of underwriting and dealing are manageable, any losses in a securities subsidiary of a bank would—under generally accepted accounting principles—be consolidated into the bank's position, an entity protected by the safety net.

An additional safeguard to protect the bank from any risk from wider financial activities, and to limit the transference of the safety net subsidy to such activities, is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions. However, it would be folly to establish prohibitions and firewalls that would eliminate the economic synergy between banks and their affiliates. The revised Leach bill retains reasonable firewalls and other prudential limitations, but provides the Board with the authority to adjust them up or down. Such flexibility is highly desirable because it permits the rules to adjust in reflection of both changing market realities and experience.

The Leach bill attempts to accommodate the merchant banking business currently conducted by independent securities firms. Both bank holding companies with Section 20 subsidiaries and independent securities firms engage in securities underwriting and dealing activities. However, independent securities firms also directly

provide equity capital to a wide variety of companies without any intention to manage or operate them. The Leach bill would permit securities firms that acquire commercial banks, as well as securities firms acquired by bank holding companies, to engage in all of these activities—underwriting and dealing in securities, as well as merchant and investment banking through equity investment in any business without becoming involved in the day–to–day operations of that business. These powers are crucial to permit securities firms to remain competitive domestically and internationally. Under the bill, the Board could establish rules to ensure that these activities do not pose significant risks to banks affiliated with securities firms or serve as a "back door" to the commingling of banking and commerce.

Some are concerned that an umbrella supervisor is incompatible with a financial services holding company with an increasing number of subsidiaries that would be unregulated if they were independent. The Board too is concerned that, if bank–like regulation were applied to an expanded range of activities, the market would believe that the government is as responsible for their operations as it is for banks. This subtle transference of the appearance of safety–net support to financial affiliates of banks creates a kind of moral hazard that is corrosive and potentially dangerous.

Nonetheless, it is crucial to understand that both the public and management now think—and will continue to think—of bank holding companies (and financial services holding companies, if authorized) as one integrated unit, especially if they enjoy the economic synergies that is the purpose of the reform proposals. Moreover, experience and the new computer technology are already adding centralized risk management to the existing centralized policy development for bank holding companies. The purpose of the umbrella supervisor is to have an overview of the risks in the organization so that *the risks to the bank* can be evaluated and, if needed.

addressed by supervisors. The umbrella supervisor, it seems to us, becomes more crucial, not less, as the risk management and policy control moves from the bank to the parent.

Balancing the supervisory needs of the bank regulators with concerns about the extension of bank–like supervision and regulation is not easy. In an effort to eliminate unnecessary regulatory constraints and burdens, the Leach bill would require the banking agencies to rely on examination reports and other information collected by functional regulators. In addition, it would require the banking agencies to defer to the SEC in interpretations and enforcement of the federal securities laws. The revised bill goes further and eliminates the current application procedure for holding company acquisitions by well–capitalized and well–managed banking organizations whose proposed nonbank acquisitions or *de novo* entry are both authorized and pass some reasonable test of scale. Your revised bill, Mr. Chairman, also streamlines the process for evaluating the permissibility of new financial activities. These are extremely important modifications both for existing bank holding companies and for securities firms that wish to affiliate with banks. Such provisions would greatly enhance the "two–way street" provisions by eliminating unnecessary regulatory burden and red tape. We believe that this concept could also quite usefully be extended to bank acquisition proposals.

The Board is also committed to continuing to develop supervisory and examination policies that appropriately reduce unnecessary burdens on organizations with bank subsidiaries that are well capitalized and well managed. But we must not lose sight, and the Leach bill does not, that the umbrella supervisor must still be permitted to monitor both the financial condition of the organization and the potential transfer of risks to the insured depository affiliates. Moreover, we reiterate our concerns of last year

that, however any restructuring is addressed, the Federal Reserve's capability to monitor large banking organizations in order to respond effectively to systemic crisis not be impaired.

Mr. Chairman, you asked for the Board's views on combining commerce and banking. While the Board supports wider permissible affiliations between banks and other financial services companies, it does not believe that, at this time, banks should be affiliated with commercial and industrial firms. The Board believes that in a free market economy there is a presumption of free entry into any business—including banking—although safeguards are required when public monies are at risk. However, the Board believes it would be prudent to delay enacting the authority to link commerce and banking until we have gained some actual experience with wider financial ownership of, and wider activities for, banking organizations. We should reflect carefully on such a basic change in our institutional framework because it is a step that would be difficult to reverse.

Your invitation letter also asked about experience with banking and commerce abroad. Our review of the industrial countries with internationally important banking sectors suggests that all seven (the non–U.S. G–7 plus Switzerland) permit limited ownership of banks by commercial firms and some ownership of commercial firms by banks. In practice, despite the legal permissibility, banking–commerce ties are limited. In none of the seven countries are any of the largest banks owned by commercial firms. Banking and commerce affiliations are much more commonly in the form of banks' holding sizable equity stakes in commercial firms, rather than vice versa. Only in Germany is bank control of commercial firms commonplace, and in that country a banking license is required to engage in any one of a number of credit services which are performed in the United States and in other countries by *nonbank* financial

institutions. In Japan, banks' equity holdings are substantial relative to bank capital, but, just as in the case of U.S. bank holding companies, a bank in Japan may not hold more than 5 percent of another company's shares.

There are two main benefits from bank ownership of commercial firms. One benefit is that such arrangements reduce the information costs associated with long–term projects, so that *ex ante* profitable long–term projects are more likely to be funded. A second benefit is that adding equities to the mix of instruments in a bank's portfolio increases the potential for portfolio diversification. However, foreign experience demonstrates that there are costs from bank ownership of commercial firms. Banking–commerce ties may induce banks to continue to finance a project beyond the point at which it is prudent to do so. In addition, equity holdings increase the sensitivity of bank capital to equity market volatility, as has been the case in Japan, thus exposing banks to additional risk. A third cost, illustrated by Germany, is the tendency for capital markets—especially equity markets—to be less fully developed under a system of bank–dominated financing.

Over the last three decades, deposit protection schemes have been established in all seven countries to avoid runs by depositors at small banks. Financial problems at larger banks are normally dealt with by cooperative efforts of commercial banks and governments. I should note that all these countries impose restrictions on banking–commerce ties in order to limit the risks resulting from such ties. As I noted, the risks associated with commercial firm control of banks appear to be limited by permitting commercial firms to control only small banks. In addition, all the countries except Japan limit the risks associated with bank ownership of commercial firms by limiting banks' total equity holdings to a fraction of bank capital. Even with these limits, recent losses stemming from bank affiliations with commercial firms, most notably at

Metallgesellschaft in Germany and Credit Lyonnais in France, have sparked public debate in these countries about the advisability of banking–commerce ties.

In the United States, the public debate continues to focus on wider affiliations between banks and other financial firms. On more than one occasion, bills to permit at least securities affiliates were approved by the banking committees in both houses, as well as by the full Senate on several occasions. In the meantime, technological change, globalization, and market innovations have continued. In such a context, modernization of our financial system should be of high priority in order better to serve the U.S. public. Consequently, the Board believes it is timely, desirable, and prudent to authorize wider affiliations between banks and other financial service providers, the approach contained in the revised Leach bill would be a major step in the modernization of our financial system, which sadly now operates under increasingly outdated restrictions and prohibitions.

TESTIMONY OF

RICKI TIGERT HELFER
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

ON

THE "FINANCIAL SERVICES COMPETITIVENESS
ACT OF 1995" AND RELATED ISSUES

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

11:30 A.M.
FEBRUARY 28, 1995
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and members of the Committee, I appreciate and welcome this opportunity to present the views of the Federal Deposit Insurance Corporation on the Financial Services Competitiveness Act of 1995, and related issues. I commend you for placing a high priority on the need for structural reform of our financial system.

The FDIC supports a repeal of the Glass-Steagall restrictions on the securities activities of commercial banking organizations, provided that this is accompanied by the appropriate protection to the insurance funds. In the financial and regulatory environment of today, the Glass-Steagall restrictions do not serve a useful public purpose. Repeal of the restrictions would strengthen banking organizations by allowing diversification of income sources and better service to customers, and would promote an efficient and competitive evolution of U.S. financial markets.

History demonstrates, however, that expansion of the activities of banking organizations must be accompanied by adequate safeguards. The controls that exist today to protect insured institutions from the risks of related nonbanking entities have generally proven satisfactory in the normal course

of business. When banking organizations have experienced severe financial stress, however, interaffiliate transactions have occurred that have resulted in material losses to the deposit insurance funds, although interaffiliate transactions were not solely responsible for any bank failures. The FDIC has a special interest in the adequacy of safeguards to protect the deposit insurance funds. Chairman Leach has recognized the need for such safeguards in the proposed Financial Services Competitiveness Act of 1995. My testimony contains several specific comments in this area.

Financial markets have changed dramatically since 1933, when the Glass-Steagall Act first imposed a separation between banking and securities underwriting activities, and since 1956, when the Bank Holding Company Act further limited the activities of bank affiliates. To a greater extent than ever before, nonbanking firms now are offering financial products that were once the exclusive domain of banks. Improvements in information technology and innovations in financial markets make it possible for the best business customers of banks to access the capital markets directly, and, in the process, to bypass traditional financial intermediaries.

Large corporations meet their funding needs through the issue of commercial paper, debt securities, equity and through loans. The Glass-Steagall restrictions prevent most banking

organizations from providing the full range of funding options to their customers. The shrinking role of banks in lending to business is illustrated by the declining proportion bank loans represent of the liabilities of nonfinancial corporations. This share declined from about 22 percent in 1974 to 13.5 percent in 1994, the lowest proportion since these data were first collected in the early 1950s. Similarly, it is noteworthy that banks have grown much less rapidly than other financial intermediaries during the past ten years. For example, during this period banking assets grew at an average annual rate of 4.9 percent, compared to growth rates of 28.7 percent and 19.8 percent for mutual funds and securities firms, respectively. Attachment A shows average annual growth rates of the assets of various types of financial institutions for the past ten years.

There is indirect evidence which suggests that as banks have lost their best business customers, they have to some extent turned to riskier ventures such as construction finance and commercial real-estate loans. Although the banking industry has experienced record profits recently, the wide swings in past performance indicate increased risks in the industry. In the last ten years, the banking industry achieved both its lowest annual return on assets (about 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance. As discussed in Attachment B, the volatile swings in the health and performance of the

industry may result in part from constraints that limit alternatives for generating profits. Restrictions that resulted in the loss of many of their best corporate loan customers, combined with the need to maintain profit margins and keep market share, led many banks to increase their concentrations in alternative high-yield assets. Some of these investments, such as construction and real estate development loans, loans to developing country borrowers and loans to finance highly leveraged commercial transactions, carried higher, sometimes unfamiliar, credit risks. Other investments, including longer-term fixed-rate securities and home mortgage loans, as well as securities derivatives, increased the interest-rate risk of banks.

Some might ask whether we are forgetting the lessons of an earlier time -- the 1920s and 1930s. Congress imposed the restrictions of Glass-Steagall in reaction to the abuses of bank securities affiliates and the perception that the abuses contributed substantially to the banking crisis of the 1930s. Attachment C to my testimony describes the historical evidence on this subject. The evidence generally suggests that the concerns that bank securities activities played a major causal role in the banking crisis were overblown, and that remedies other than the Glass-Steagall restrictions would have addressed the abuses more effectively.

When the historical debate is finished, however, we come to this: we have in place today a regulatory structure of comprehensive banking and securities regulation that did not exist in 1933, including restrictions on interaffiliate transactions. Repeal of the Glass-Steagall prohibitions will be a vote of confidence in that regulatory structure. On balance, I believe the risks can be contained and that the benefits outweigh the costs.

Finally, I would argue that any easing of restrictions on banking organizations should proceed in a cautious, incremental manner. Banking organizations have expertise in managing certain financial risks. We should develop a body of experience to evaluate the safety-and-soundness implications of any new financial affiliations, before allowing broader affiliations with firms exposed to a different range of risks. The limited, but generally successful, experience of the affiliation of savings associations with commercial firms may provide a useful starting point for such an evaluation in the future. However, it does not provide a clear model for intermingling the more comprehensive risk profile of banking with commercial activities.

My testimony will first summarize the special concerns of the FDIC, as deposit insurer, with respect to expanded activities of bank subsidiaries and affiliates. Next, I will discuss the safeguards that are necessary to protect the deposit insurance

funds and the financial system. I will then review the advantages and disadvantages of particular organizational structures with respect to the location of new securities activities. The balance of my testimony will focus on specific provisions of the Financial Services Competitiveness Act of 1995.

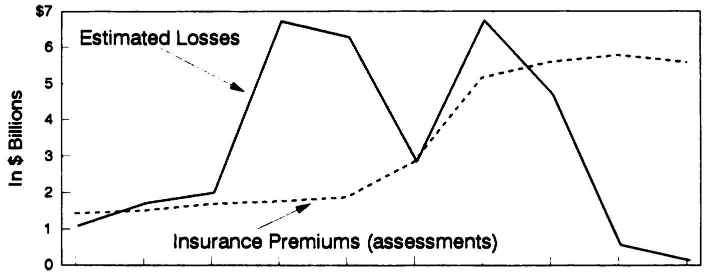
PERSPECTIVE OF THE DEPOSIT INSURER

As the deposit insurer, the FDIC has a vital interest in the safety and soundness of insured institutions and the integrity of the deposit insurance funds. Events of the past decade have demonstrated how costly deposit insurance can be. The Bank Insurance Fund (BIF) and the banking industry have spent almost $33 billion to resolve failing banks in the period from 1985 to 1994 (see Figure 1). The thrift crisis, in contrast borne by the taxpayers, has been estimated to cost $150 billion.

We cannot attribute all of the insurance losses to economic events or poor management of depository institutions. A significant share of the responsibility must be assigned to poorly planned deregulation and ineffective supervision in some areas. Thus, it is imperative that we proceed deliberately as we contemplate a substantial expansion of the powers available to banking organizations.

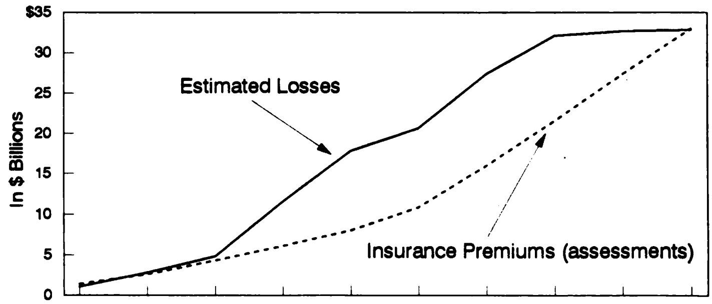
FIGURE 1

Deposit Insurance Cost - Ten Years Ending 1994
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	1,722	2,007	6,721	6,273	2,856	6,739	4,695	570	139
Insurance Premiums (assessments)	1,433	1,517	1,696	1,773	1,885	2,855	5,161	5,588	5,784	5,591 *

Cumulative Deposit Insurance Cost - Ten Years Ending 1994
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	2,821	4,828	11,549	17,822	20,678	27,417	32,112	32,682	32,821
Insurance Premiums (assessments)	1,433	2,950	4,646	6,419	8,304	11,159	16,320	21,908	27,692	33,283 *

* The 1994 figure reflects rebates to some institutions that appealed their 1993 assessments.
Sources: 1993 FDIC Annual Report and FDIC Failed Bank Cost Analysis, 1986 - 1993. Figures for 1994 are preliminary.

In the last ten years, there have been 1,368 failures of institutions insured by the Bank Insurance Fund, accounting for almost two-thirds of the 2,121 failures that have occurred since the inception of federal deposit insurance in 1933. These failed banks had combined assets of $236 billion, and cost an estimated $32.8 billion to resolve. The number of failures reached an annual record level of 221 in 1988, while the losses and combined assets of failed banks peaked in 1991. The thirteen bank failures in 1994 were the fewest since ten banks failed in 1981, and speak to the significantly improved financial condition of the banking industry.

While a number of factors contributed to the rise and decline of bank failures during this period, two elements -- the phenomenon of "rolling regional recessions," coupled with constraints on geographic diversification in some regions -- are reflected in the geographic patterns of failures. The agricultural Midwest, the Southwestern oil states, New England, and California all experienced sharp increases in bank failures in the past decade, stemming in large part from regional economic downturns. In general, the largest losses to the FDIC occurred in those states where regional recessions have been most severe.

The most costly failures can be linked to excessive concentrations in commercial real-estate lending and construction and land development loans. Rapid accumulation of these loans

preceded the rise in failures in the Southwest and Northeast, the regions where the FDIC losses were greatest. An FDIC study published in 1990 found that failing banks in Texas increased their concentrations in these assets long after the decline in local real-estate markets had begun. Failed savings banks in New England also had much higher proportions of their balance sheets invested in construction and land development loans, where they had little previous experience.

There are two lessons to be drawn from these experiences. First, inadequate diversification of income sources is dangerous for banking organizations. This is an argument in favor of the repeal of the Glass-Steagall restrictions. Second, rapid growth in lending by insured institutions -- particularly in unfamiliar activities -- can result in significant losses. This emphasizes the need for strong supervision and monitoring by the regulators using adequate safeguards to protect insured financial institutions.

The Demise of the FSLIC

The experience of the thrift industry in the 1980s serves as an even stronger reminder of the importance of maintaining safety and soundness standards. The highlights of the experience bear repeating as we consider the expansion of activities of banking organizations. In the early 1980s, most of the thrift industry

was economically insolvent due to interest-rate-induced losses from lending longer term at lower interest rates and borrowing short-term at higher interest rates. Rather than address the problems directly, the political and regulatory response was to relax capital and accounting standards, forbear from closing insolvent institutions, and expand the powers available to thrifts.

Federal legislation in the early 1980s significantly liberalized the permissible assets of thrifts. By 1982, thrifts could make commercial mortgage loans of up to 40 percent of assets, consumer loans up to 30 percent of assets and commercial loans and leases each up to 10 percent of assets. By midyear 1983, the Federal Home Loan Bank Board (FHLBB) allowed federally chartered savings and loan associations to invest up to 11 percent of their assets in high-risk bonds. Direct equity investments in real estate, equity securities and in subsidiary service corporations were permitted up to three percent of assets. Several states permitted state-chartered institutions significantly greater scope for direct investments. The attempt by many troubled institutions to use the new powers to "grow themselves out of their problems" added substantially to the cost of the thrift crisis.

Some might argue that the experience of thrifts in the 1980s is irrelevant today. I would disagree. Wherever there is a

government guarantee, there will be some who attempt to exploit it inappropriately. Mechanisms must be in place to contain these risks. In addition, the supervisory staff that has been trained to detect losses from traditional activities will need to become familiar with the risks and potential losses associated with the new activities.

We also must keep in mind the extent to which a strong deposit insurance system depends on a sound regulatory structure as we eliminate the Glass-Steagall barriers. Securities activities of banking organizations should be subject to the regulation of the Securities and Exchange Commission (SEC). As securities activity increases in the banking industry, so will the role of functional regulation and the need to coordinate the distinct regulatory approaches. Supervision has been the keystone of the regulation of commercial banking, while disclosure and market discipline have been the key elements of securities regulation. The challenge will be to combine these approaches in a seamless fashion that permits no gaps that might threaten the insurance funds, and yet avoids burdening banks with regulatory overlap.

Finally, as banking organizations enter new activities, care should be taken to confine deposit insurance protection appropriately. Securities markets in the United States are dynamic and innovative; they have expanded the growth potential

of the economy and have become the envy of the world. Our securities markets do not need the backing of the deposit insurance guarantee, nor do they need the added requirements of bank regulation that come with it. To promote the continued efficiency of securities markets, as well as to protect the insurance funds from undue risk, it is critical to separate the insured entity from the securities units of the banking firm. This will be addressed more extensively in the following discussion of necessary safeguards to the insurance funds and the appropriate structure for the conduct of new activities by banking organizations.

PROTECTION FOR THE INSURANCE FUNDS

My testimony has emphasized that in expanding the securities activities of banking organizations, we must not lose sight of the need to maintain the safety and soundness of insured institutions. This requires protection against inappropriate transactions between insured institutions and their securities subsidiaries and affiliates.

In general terms, there are two areas of concern from an insurance standpoint with respect to transactions between an insured institution and a related securities firm. The first involves the inappropriate use of an insured institution to benefit a related securities firm in the course of business. A

second arises when an insured institution is in danger of failure. In the latter situation, there is an incentive for the owners and creditors of the related entities to extract value from the insured entity prior to its failure in order to maximize the share of losses borne by the FDIC and minimize their own losses. The FDIC's experience suggests useful lessons regarding necessary protection for the insurance funds in both areas.

There are numerous ways an insured institution could benefit a related securities firm in the course of business. These include: direct equity injections to a securities subsidiary; upstreaming of dividends to a parent that are used to inject equity to a securities affiliate; purchasing of assets from, or extensions of credit to, the related firm; issuing a guarantee, acceptance or letter of credit for the benefit of the related firm; extending credit to finance the purchase of securities underwritten by the related firm; and extending credit to the issuers of securities underwritten by the related firm for purposes of allowing the issuers to make payments of principal, interest or dividends on the securities.

There are three main dangers in such transactions from the standpoint of the deposit insurer. First is the danger that the consolidated entity will attempt to use the resources of the insured institution to promote and support the securities firm in a way that compromises the safety and soundness of the insured

institution. An equally important concern is that the business relationship between the insured entity and the securities firm will create a misperception that the investment products of the securities firm are federally insured. Finally, there is the danger that the business and operating relationship will cause the courts to "pierce the corporate veil" -- that is, to hold the insured entity responsible for the debts of the securities firm in the event the securities firm fails.

Current law provides a number of safeguards against these dangers. Attachment D provides a summary of some of the major provisions. We must be concerned with how well these safeguards will work after Glass-Steagall restrictions are lifted. The experience with the involvement of banks with securities activities has to this point been limited, but generally favorable. Since 1987, the Federal Reserve has allowed limited securities activities in so-called "Section 20 subsidiaries" of bank holding companies. The Federal Reserve indicates that there have been no instances in which a Section 20 subsidiary adversely affected an affiliated bank. There are currently 36 bank holding companies that have Section 20 subsidiaries; these subsidiaries range in size from a few million dollars in assets to tens of billions of dollars in assets. There has been one failure of an insured institution affiliated with a Section 20 subsidiary. The Section 20 subsidiary played no role in causing the failure, however.

U.S. banks also are permitted to engage in securities activities overseas within various percentage and dollar limitations. Typically these activities are conducted by subsidiaries of Edge Corporations, which, in turn, are generally subsidiaries of U.S. banks. Federal Reserve staff indicate that these activities have not posed any significant safety and soundness problems for U.S. banks.

The FDIC permits institutions it supervises to engage in securities activities through "bona fide subsidiaries" -- that is, subsidiaries that meet certain criteria designed to ensure corporate separateness from the insured banks. A detailed description of these subsidiaries and the FDIC's regulatory safeguards in place to insulate the insured institution is included in Attachment D. More limited activities are permissible to subsidiaries that do not meet the "bona fide" test.

The experience of banking organizations conducting securities activities through such subsidiaries has been limited. Currently, only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC. There are, however, over 400 insured nonmember banks that have subsidiaries engaged in more limited securities-related activities. These include management of the bank's securities portfolio, investment advisory activities, and

acting as a broker/dealer. With one exception, none of these activities has given cause for a significant safety and soundness concern.

There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary. While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure. The bank made a substantial unsecured loan that was used to benefit the securities subsidiary. This transaction was in compliance with the restrictions on affiliate transactions of Section 23A because Section 23A does not apply to transactions between a bank and its subsidiary. This is an area where Congress should consider strengthening the provisions of Section 23A to apply to subsidiaries of the bank engaged in securities activities.

The experience with bank-sponsored mutual funds has also been free of substantial safety and soundness concerns. Nevertheless, this experience demonstrates that the mixing of banking with securities activities is not without risk. Within the last year, 12 banking organizations have elected to provide financial assistance to their proprietary money-market mutual funds. The assistance has ranged from $1 million to about $83 million. The decisions to provide assistance presumably reflected business judgments that weighed the cost of the

assistance against the loss of reputational capital that these organizations would have sustained if investors in their mutual funds had suffered losses.

None of these episodes posed any serious safety and soundness concern to the insured entities. In all but two cases, the assistance was provided by the holding company rather than the bank, and in no case did the assistance exceed approximately one percent of the consolidated capital of the holding company. Nevertheless, the instances serve as a reminder that banking organizations can have an incentive to manage their businesses as a unit, and the result may involve the transfer of resources among affiliates that can adversely affect the insured entity.

To summarize, the affiliation of banking and securities activities as it currently exists in both bank subsidiaries and bank affiliates has, in general, not presented significant safety and soundness concerns. This experience suggests that current safeguards are for the most part adequate and that any reform of Glass-Steagall should include similar safeguards against dealings between the insured bank and a securities affiliate.

Although the experience thus far has been generally positive, it has been limited. As mentioned above, we have not seen the combination of a failed or severely distressed bank that was associated with significant securities activity. This is

important from the perspective of the deposit insurer because the past decade provided examples where distressed banks breached statutory or regulatory protection of the insured bank to the detriment of the FDIC.

While none of the interaffiliate transactions were solely responsible for the failure of any insured institutions, there were a number of instances where "deathbed transactions" were proposed or consummated that served to advantage the holding company or an affiliate at the expense of the insured bank. The transactions often involved sums in the tens of millions of dollars. Not all of these transactions required regulatory approval. The regulators often, but not always, denied those that did.

Unpaid tax refunds arose as an issue in more than one case. Bank holding companies generally receive tax payments from and downstream tax refunds to their banking subsidiaries, acting as agent between the bank and the IRS. The FDIC has observed that in some cases unpaid tax refunds tended to accumulate on the books of failing bank subsidiaries, leaving the cash with the holding company. This practice took place without regulatory approval.

Consolidation of nonbank activities at the parent level is another way to transfer value away from insured bank

subsidiaries. One notable case involved the consolidation of trust operations at the subsidiary banks into a single parent-owned company that was later sold at a profit. When service company affiliates carry out data processing or other activities for banks, the issue of intercompany pricing also is raised. In one case the FDIC observed a large and retroactive increase in charges by an asset management company to troubled bank affiliates. In other cases, service company affiliates failed to provide promised overhead reimbursement for the use of bank premises.

Linked deals involving the sale of purchased mortgage servicing rights have in some cases been used either to subsidize the sale of a holding company asset or to allow the bank subsidiary to book an accounting gain. The effect of a linked deal may be to either transfer value to the parent or delay the closing of a subsidiary without the benefit of needed fresh capital.

Finally, there have been instances of "poison pills" created by interaffiliate transactions. In one case, key bank staff were transferred to the holding company payroll, apparently to reduce the attractiveness of bringing in an outside acquirer. Interaffiliate data processing contracts also have been structured so as to limit the availability of information to the

FDIC or an acquirer after the bank was closed, thereby making regulatory intervention more costly.

To summarize, factors other than interaffiliate transactions typically have caused the failure of FDIC-insured subsidiaries of bank holding companies. However, such transactions were used in several cases to extract value from the insured bank just prior to its failure at the expense of the deposit insurance fund. This generally did not come about through excessive dividends or the transfer of blatantly misvalued assets. They more often came about through the pricing of services traded between affiliates, early retirement of subordinated debt and linked deals involving third parties. These transactions probably added tens of millions of dollars to the losses realized in resolving these large banking organizations.

Some of the most spectacular examples of inappropriate intercompany transactions come from the thrift industry in the 1980s. Thrifts have traditionally spawned a variety of subsidiary service corporations to perform tasks such as mortgage servicing, brokerage, title insurance and other types of insurance. With the liberalization of federal and state restrictions on direct real estate investment in the early 1980s, the real estate development subsidiary became a common vehicle for these activities. However, while federally chartered institutions in the early- to mid-1980s were limited to investing

three percent of assets in these activities, state-chartered institutions in California and Texas could make virtually unlimited direct investments.

Two factors made this liberalization of powers particularly conducive to creating losses for the Federal Savings and Loan Insurance Corporation (FSLIC) and later the Resolution Trust Corporation (RTC). First, under regulatory accounting practices, direct investments in subsidiaries were carried on the books of the parent thrift at historical cost, instead of their market value, which was often considerably lower. Second, thrift regulators as a rule neglected to conduct detailed examinations of subsidiary operations. Under these conditions, thrift managers were free to invest in residential and commercial real estate development activities with which they had little experience, and when these projects became problematic they could use a variety of transactions to hide the losses. The thrift could make unsound loans to help sell new properties built by the subsidiary. In some cases the thrift would sell the note to the subsidiary, removing it from the balance sheet for a period.

An empirical study of the reported earnings of direct investment subsidiaries of federally insured thrifts from 1980 to 1985 shows that profitability declined dramatically as the size

of the subsidiary grew as a percentage of total thrift assets.[1] This is consistent with the observation that the real estate subsidiaries were a dumping ground for hidden thrift losses in the 1980s.

Our review of the examples described above suggests that, for the most part, the problem has not been that the existing protections were inadequate. Instead, it appears that the regulatory community has been reluctant at times to enforce these protections. This reluctance is understandable to some extent, given the considerable uncertainties that surround banks in distress and the desire to mitigate market pressures that may unnecessarily aggravate the plight of those banking organizations that have a chance to survive.

What steps can be taken to encourage more vigilant enforcement of protections? First, the enforcement of safeguards against transactions between an insured bank and its securities affiliates should allow for few exceptions. Congress should consider whether the perspective of the FDIC as insurer would be useful in identifying through guidelines or other means, those limited areas where exceptions to the safeguards may be beneficial without creating the potential for losses to the

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[1] Rosen, R.J., Lloyd-Davies, P.R., Kwast, M.L. and Humphrey, D.B. 1989. "New Banking Powers: A Portfolio Analysis of Bank Investment in Real Estate." Journal of Banking and Finance 13 (1989): 355-66.

insurance funds. In addition or in the alternative, it may be useful to develop an interagency codification of the standards for enforcing sections 23A and 23B of the Federal Reserve Act, so that insured financial institutions and all regulatory agencies will have clear notice and fuller understanding of the nuances of these safeguards. We should also consider increasing the protections of Section 23A with respect to extensions of credit and similar transactions between a bank and its wholly owned subsidiary. Second, while sound business judgment should dictate when healthy, well-capitalized banks provide support to related entities, such support should come through the transfer of excess bank capital -- beyond the capital required for a well-capitalized bank -- not through the relaxation of safeguards such as those discussed earlier. For bank holding companies, this means the well-capitalized bank could provide dividends that allow the parent to provide support to non-bank subsidiaries. For banks conducting activities in subsidiaries, the bank could make additional equity investments in the subsidiary and those investments should be deducted from bank capital before determining whether the insured bank meets the standard of being well-capitalized.

In addition, bank regulators may want to consider whether to require real-time reporting of intercompany transactions under certain conditions, as the SEC does in some contexts. These

requirements may be tied to the capital level of the bank, the size of the transaction, or other relevant factors.

As the deposit insurer, it is the FDIC's responsibility not only to protect depositors when a bank fails, but also to learn from the failure of that bank. The FDIC is prepared to provide information and analysis to fellow regulators where there is evidence that intercompany transactions have contributed to the failure of, or increased the cost of resolving, an insured institution. Such reports would contribute to an increased understanding and awareness of these issues, and we believe ultimately would promote improved enforcement of the safeguards.

STRUCTURAL ISSUES

An important consideration in the deliberations concerning the possible combination of traditional commercial banking and securities activities is the organizational structure under which such combinations would be permitted. The perspective of the deposit insurer focuses on two issues: the ability to insulate the insured bank from the risks of the securities underwriting activities and the burdens and inefficiencies associated with a particular regulatory structure. The following analysis addresses these issues.

There are two organizational structures with which we have experience in the United States that can be used to combine commercial and securities underwriting activities. These are: (1) the conduct of each activity in separate organizations owned and controlled by a common "parent" organization (the "bank holding company" model); and (2) the conduct of each activity in a separate organization, one of which owns and controls the other entity (the "bona fide subsidiary" model). A third model -- the conduct of both activities within the same entity (the "universal banking" model) -- has been used in some other developed countries. For reasons discussed in Appendix B, I believe that universal banking is not a model that would best fit the dynamic financial marketplace in the United States or provide sufficient protection for the deposit insurance funds against the effects of potential conflicts of interest between banking and nonbanking functions in an insured entity.

The Bank Holding Company Model

Since the adoption of the Bank Holding Company Act of 1956, one of the primary methods of expanding permissible activities beyond those associated with traditional commercial banking has been through formation of affiliated entities within the bank holding company umbrella. Within this framework, banking organizations have been permitted to engage in an increasing array of financial services. Most recently, some bank holding

companies have been permitted by the Federal Reserve to engage in corporate securities underwriting activities through so-called "Section 20" subsidiaries. Attachment E describes in detail the prohibitions and restrictions on securities activities that are imposed by Section 20 of the Glass-Steagall Act and by the Bank Holding Company Act.

In terms of the criteria for safeguards set forth earlier, the bank holding company model has considerable merit. The advantages include:

- Provision of a good framework for monitoring transactions between insured and non-insured affiliates and for detecting transfers of value that could threaten the insured institution; and

- Maintenance of a meaningful corporate separation between insured and non-insured organizations to assure that nonbank affiliates have no competitive advantages from the insured status of the bank.

The disadvantages of the bank holding company model include:

- In distressed situations, the parent will have the incentive to transfer or divert value away from the insured bank, leaving greater losses for the FDIC if the bank ultimately fails; and

- The holding company model requires bank owners to establish and maintain an additional corporation. This may add costs, inefficiencies, complexity and, in some cases, an additional regulator.

Bona Fide Subsidiary Model

From a practical perspective, there has been less experience with the "bona fide" subsidiary form of organization than with the bank holding company form. However, the experience discussed earlier in this testimony supports the view that direct ownership of a securities firm by an insured bank need not be significantly different from the bank holding company model in terms of affording protections to the deposit insurance funds, and may have some additional advantages.

Analytically, there are several factors that make this approach different from the bank holding company model. The advantages of the bona fide subsidiary approach include:

- The residual value of the subsidiary accrues to the bank, not the holding company; and

- The bank, rather than the parent, controls the allocation of excess capital of the organization. This may mean that in making corporate investment decisions,

greater weight will be given to the needs of the insured bank. Financial investments will be structured to diversify the risks of the bank's portfolio, while investment in systems and physical capital will benefit the operations of the bank.

However, on the negative side:

- While corporate separateness theoretically can be maintained regardless of organizational structure, in practice, a bank holding company structure may be a more effective vehicle for this purpose;

- Inappropriate wealth transfers may be more easily executed if made directly to a subsidiary, rather than indirectly to the parent and then to an affiliate; and

- Consolidated earnings of a bank that includes a fully consolidated securities firm may exhibit more volatility than the bank alone. This may be negatively perceived by the market, and might inhibit the ability of banks to raise capital or attract funds at market rates.

Based on these observations, it is clear that there are advantages and disadvantages to both models. Furthermore, the

safeguards that are necessary to protect the insured bank and ultimately the insurance funds can be similar for either structure. If these safeguards are in place and enforced, either approach will work. If safeguards are inadequate or there is not a strong commitment to enforcing them, the deposit insurance funds, the financial system and the public will suffer, regardless of which model is used.

In the final analysis, I favor allowing financial institutions to choose the model that best suits their business needs, as long as strong safeguards are in place to protect the insurance funds. I see no reason for current legislation, which is based on a progressive vision of the evolution of financial services, to mandate a particular structure. A combination of flexibility and sound regulation has contributed to the successful development of the U.S. financial system, and these key elements should be present in any proposal for reform.

COMMENTS ON THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

Mr. Chairman, I want to commend you again for holding this hearing and for introducing legislation to serve as a focus for debate on how best to achieve financial services reform. The Financial Services Competitiveness Act of 1995, as revised on February 24 ("the bill"), is designed to enhance competition in the financial services industry by providing a prudential

framework for the affiliation of banks and securities firms. It accomplishes this by eliminating current statutory restrictions on these affiliations and establishing a comprehensive framework for affiliations within a holding company structure overseen by the Federal Reserve.

As discussed earlier in my testimony, the protections against inappropriate intercompany transactions provided in the bill are sound. However, I am concerned about the degree to which exceptions to these restrictions would be possible. In addition, provided the appropriate protections are in place, I would support an approach that allows a commercial bank the flexibility to conduct securities activities in an affiliate of its holding company where the bank has a holding company or wishes to organize one, or in a subsidiary of the bank where that approach more effectively conforms to the business plan of the organization. I do not believe the advantages to the bank holding company structure are so pronounced as to justify imposing additional costs on the banking system by mandating a particular structure.

Criteria for Approval

Under the bill, any expanded authority may be exercised only through a financial services holding company structure and only when the Federal Reserve has concluded that certain procedural

safeguards have been met. The criteria outlined in the bill are sensible and appropriate.

Only financial services holding companies that are adequately capitalized are eligible to acquire a securities affiliate. For purposes of determining whether a financial services holding company is adequately capitalized, the holding company's capital and total assets are reduced by the holding company's equity investment in any securities affiliate, and further reduced by certain extensions of credit to any securities affiliate.

In addition, the lead bank within the holding company must be well-capitalized before the holding company is eligible to acquire a securities affiliate. Moreover, 80 percent of the total assets of the financial services holding company's insured depository institutions must be controlled by well-capitalized institutions. We support these provisions. I believe these provisions help to preserve a strong capital cushion for the bank and the financial services holding company as a possible source of strength for its banking subsidiaries.

The bill properly provides an incentive to financial services holding companies and their depository institutions to maintain adequate capital levels after they have been allowed to affiliate with a securities company. In the event the lead

depository institution drops below the well-capitalized category, or if well-capitalized institutions cease to control 80 percent of the assets of the insured depository institutions within the holding company, the securities affiliate cannot agree to underwrite or deal in any securities 180 days after the capital deterioration, with limited exceptions. We agree that, under these circumstances, the securities affiliate should be barred from agreeing to underwrite or deal in any securities.

At the same time, however, we note that the bill gives the Federal Reserve the authority to waive the capital safeguards for up to two years if the financial services holding company submits a recapitalization plan for the banks. We have an interest in assuring that a waiver will be granted only in situations where greater safety and soundness can be expected to result and losses to the insurance fund are not likely to be increased. For that reason, we want to work with the Federal Reserve on an interagency basis to develop guidelines on when waivers of these safeguards would be appropriate. Moreover, we believe that the time-frame preceding divestiture contemplated by the bill may be unduly long.

In addition to capital conditions, the bill imposes a broad array of managerial safeguards. The holding company and all of its insured depository institutions must be well-managed. The holding company must have adequate policies and procedures in

place to manage any potential financial or operational risks. The financial services holding company must have the "managerial resources" necessary to conduct the securities activities "safely and soundly." Finally, the acquisition must not adversely affect the safety and soundness of the financial services holding company or any insured depository institution subsidiary of the holding company. These operational safeguards are well-designed to insulate federally insured banks from the risks of securities activities.

The bill also places several interaffiliate safeguards on the relationship between a securities firm and its affiliated bank or parent holding company. For example, an insured depository institution affiliated with a securities affiliate is prohibited from extending credit to the securities affiliate, issuing a guarantee, acceptance, or letter of credit for the benefit of the securities affiliate or purchasing assets of the securities affiliate for its own account. I support these safeguards. Moreover, we should take this opportunity to strengthen the 23A safeguards governing extensions of credit between a bank and its subsidiary. In moving from a framework based on prohibition to one based on regulation, prudential safeguards such as those set forth in the bill will avert the hazards Glass-Steagall was intended to prevent. However, I am concerned that the bill would permit exceptions to the safeguards. I believe these exceptions should be granted

rarely and then only after potential losses to the insurance fund are considered, perhaps in consultation with the FDIC.

I also support the additional safeguards for director and senior executive officer interlocks. Finally, I support the various public disclosures included in the bill. In particular, I strongly support the requirement that customers be informed that the securities offered or sold by securities affiliates of insured banks are not federally insured deposits. This is an important protection for these customers and for the deposit insurance funds.

Functional Regulation

With respect to regulation, the bill calls upon the banking agencies and the Securities and Exchange Commission to work together to ensure compliance with the securities laws. As I mentioned earlier in my statement, functional and supervisory regulation must be seamless to be effective. By calling for the banking agencies and the SEC to share information, the bill promotes this goal by facilitating coordination among the regulatory agencies and by reducing the possibility of duplicative supervisory and reporting burdens.

Securities Firms

The bill creates the possibility for securities firms to become affiliated with banks by acquiring an insured bank and becoming a financial services holding company. In circumstances where more than 50 percent of a company's business involves securities activities, the bill allows the company five years, with the possibility of an additional five-year extension, to divest its nonfinancial activities. In addition, such a company could be permitted to continue holding any subsidiaries engaged in financial activities that the Federal Reserve has not authorized if the company acquired the subsidiaries more than two years prior to its becoming a financial services holding company and the aggregate investment by the company in these subsidiaries does not exceed ten percent of the total consolidated capital and surplus of the company. The company would not be permitted to engage in any new activities not otherwise authorized by the bill once it becomes a financial services holding company. This means that some securities companies that become financial services holding companies could be permitted to engage in activities not otherwise permitted generally to financial services holding companies.

I support in general the two-way street approach of the bill. If it is understood that prudential restrictions may be imposed by the Federal Reserve where necessary to protect the

safety or soundness of an insured institution with respect to a grandfathered affiliate's activities, I see no reason to go further and require divestiture. Further, it should be clear that each of the banking agencies should be able to apply the full panoply of enforcement powers, ranging from cease-and-desist actions to deposit insurance termination, in order to protect an insured bank and the deposit insurance funds.

Wholesale Financial Institutions

The bill provides the additional option of an "investment bank holding company" ("IBHC") that would be allowed to engage in a broader range of financial activities but could conduct banking activities through a "wholesale financial institution" ("WFI"). WFIs would be uninsured state member banks that could, with certain exceptions, only take initial deposits over $100,000. This provision allows for a wholesale banking operation to conduct a broader range of financial services activities without exposing the deposit insurance funds to the risks of these activities.

The IBHC concept may prove attractive to some financial firms and may even cause some FDIC-insured banks to consider terminating their deposit insurance. The proposed IBHC appears to the FDIC to be sound so long as there is clear disclosure to the public of the uninsured nature of commercial bank operations

and the exceptions for initial deposits of $100,000 or less are appropriately limited and clearly defined for public disclosure purposes.

Voluntary Termination of Insured Status

In order to facilitate transition by existing insured depository institutions to WFI status, the bill adds a new section governing voluntary termination of deposit insurance and repeals certain provisions of the FDI Act on such termination. The bill would permit an "insured State-chartered bank" or a national bank to voluntarily terminate its status as an insured depository institution upon six months written notice to the FDIC, the Federal Reserve, and the institution's depositors. However, savings associations as well as insured depository institutions excepted from the Bank Holding Company Act definition of "bank" would no longer be eligible to voluntarily terminate insured status. We believe these institutions, which are presently authorized under the law to leave the federal deposit insurance system, should continue to have that option.

The primary purpose of this new section of the bill is presumably to protect depositors when insured institutions convert to non-insured status. We agree that depositor protection must be paramount when any insured institution voluntarily relinquishes its insured status.

Under current law, an insured depository institution must obtain prior written consent of the FDIC before it may convert to non-insured status. The FDIC weighs several factors prescribed by statute in deciding whether to grant or withhold such consent. The bill does not amend or repeal these provisions; the FDIC's power to disapprove any institution's conversion from insured to non-insured status would continue without change. The voluntary termination procedures specified in the bill, however, differ somewhat from these consent requirements found elsewhere in the FDI Act. Consequently, it would be appropriate to clarify the bill to assure consistency of the various termination provisions. The bill could be clarified by including a provision that the bill does not override the provisions of Section 18(i) of the FDI Act.

The bill provides that a depository institution that voluntarily elects to terminate its insured status shall no longer receive insurance of any of its deposits after the specified transition period. It also should be made clear that this provision is not intended to bar a formerly-insured institution from reapplying for federal deposit insurance.

Under the bill, any institution that voluntarily terminates its status as an insured depository institution is prohibited from accepting deposits unless the institution becomes a WFI. If

the institution becomes a WFI, it may not accept any initial deposit that is $100,000 or less other than on an incidental and occasional basis. These prohibitions limit the flexibility non-insured institutions now have under federal law. It is not clear why the law should compel institutions that have voluntarily terminated insurance to obtain WFI status so that they can accept deposits where state law permits other kinds of uninsured entities. The flexibility non-insured institutions enjoy under current federal law should not be diminished without good cause. The bill can be improved by clarifying its termination provisions along the lines I have just outlined.

Bank Mergers

The bill would amend the Bank Merger Act to allow the merger, consolidation, or acquisition of assets or the assumption of liabilities among insured depository institutions that are subsidiaries of the same holding company without the prior approval of the appropriate Federal banking agency. We are concerned that such acquisitions might weaken one depository institution at the expense of another. This proposed change in the law should be carefully considered before it is adopted by the Congress.

In conclusion, the bill represents a thoughtful approach to easing the restrictions between commercial and investment

banking. It provides for prudential safeguards and appropriate restrictions designed to insulate insured institutions from the risks inherent in investment banking activities. It is an important foundation for considering the most effective and efficient approach by which appropriate financial services reform can be achieved.

CONCLUSIONS

The restrictions of the Glass-Steagall Act do not serve a useful purpose. Their repeal would strengthen banking organizations by helping them to diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States. History demonstrates, however, that a significant expansion of the powers available to insured institutions must be accompanied by appropriate safeguards for the insurance funds. Chairman Leach has recognized the need for such safeguards in the proposed bill.

Existing experience with the combination of banks and securities firms suggests that in general current safeguards have been adequate to prevent significant safety and soundness concerns in the normal course of business. This experience has been limited, however; in particular, we have not seen a severely distressed banking organization that had significant securities activities.

The experience of the FDIC has been that in times of financial stress, banking organizations may attempt to engage in transactions that transfer resources from the insured entity to the owners and creditors of the parent company or nonbanking affiliates. In some cases the FDIC has suffered material loss as a result of such transactions. We seek to assure that reform of Glass-Steagall is not the vehicle for more such episodes.

My general comments on the safeguards against inappropriate intercompany transactions in the proposed bill are as follows. First, exceptions to the safeguards should be allowed rarely, and then only after taking account of potential losses to the insurance funds. While there should be room for supervisory discretion and the exercise of good business judgment in determining whether a healthy bank may support an affiliate, such support should be provided through transfers of excess capital -- beyond that required for a well-capitalized bank -- not through relaxations of restrictions on intercompany transactions. Second, it could be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act. We may also want to use this occasion to strengthen the safeguards in Section 23A between a bank and its subsidiary. To promote improved enforcement of the safeguards, the FDIC is prepared to provide information and analysis to fellow regulators on instances where intercompany transactions

contributed to the failure of, or increased the cost of resolving, an insured institution.

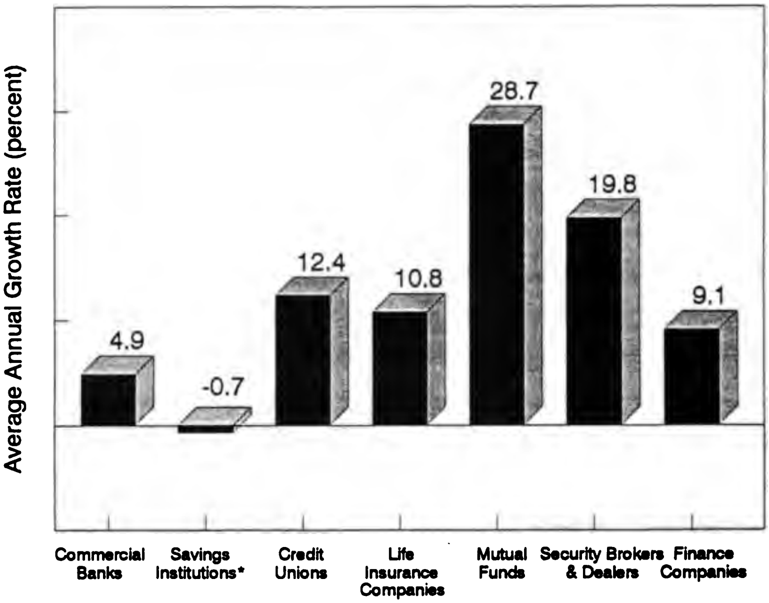
There are two United States models for conducting the new securities activities within banking organizations -- the holding company model and the bona fide subsidiary model. There are advantages and disadvantages both to housing the securities activities in bank subsidiaries, and to housing the activities in holding company affiliates. On balance, I do not believe the case for either approach is strong enough to warrant dictating to banks which approach they must choose. Banks should be able to chose the corporate structure that is most efficient for them, provided adequate safeguards are in place to protect insured financial institutions and the insurance funds.

In general, the proposed bill is a sound and constructive approach to evaluating how best to reform our financial system. The FDIC stands ready to assist the Committee with this important effort in the weeks and months ahead.

ATTACHMENT A

Average Annual Growth Rates of Financial institution Assets

Ten Years Ending 6/30/94



*FDIC-Insured Savings Institutions, includes savings banks, savings associations and S&Ls.

Source: Flow of Funds, Federal Reserve System; FDIC Research Information System; National Credit Union Administration.

Asset growth rates are expressed as annual averages for the 10-year period 6/30/84 to 6/30/94, adjusted for compounding.

ATTACHMENT B

THE CHANGING FINANCIAL MARKETPLACE

Banking was a simpler business in the early decades of the Federal Deposit Insurance Corporation. Interest rates were regulated and stable. Competition from nonbanking companies was limited. Banks were the primary source of borrowed funds for even the strongest, best-established businesses. In more recent years, the financial services industry, technology and capital markets have evolved, creating new risks and new opportunities. Bankers have had to manage the risks, but the Glass-Steagall Act and other legislation limit the ability of bankers to mitigate risk by diversifying their sources of income.

Tables I-A and I-B show that credit-risk exposure has increased dramatically since enactment of the Glass-Steagall Act. In 1935, about one-third of the industry's balance sheet was concentrated in assets that bear significant credit risk. Now, over 60 percent of banking assets are exposed to credit risk.

Beginning in the mid-1960s and lasting through the mid-1980s, the industry experienced rapid asset growth, typically exceeding ten percent per year (See Table I-A). In that 20-year span, the assets of the industry increased nearly tenfold, from $345 billion to almost $3 trillion. This growth was achieved by increasing credit risk and decreasing the proportion of lower risk investments. During this period, commercial banks built up large portfolios of loans with concentrated credit risk including loans with large balances at risk to a single borrower.[1]

The industry's growing credit-risk exposure is illustrated in Tables I and II. In 1935, about one-quarter of the balance sheet was invested in loans with "credit-risk concentrations." That level increased to almost 45 percent in 1984 (prior to the wave of recent bank failures), and has declined to 34 percent more recently. Until the early 1980s, asset growth was fueled by commercial and industrial ("C&I") loans. C&I loan concentrations reached their highest level in 1982, peaking at nearly 25 percent of the industry's balance sheet. There were some notable lending excesses during these boom years, including real estate investment trusts, less-developed-country loans, and energy credits.

In the early 1980s, the largest commercial borrowers learned to bypass banks and replace loans from banks with lower-cost commercial paper. Burgeoning loan demand from energy related businesses supported continued C&I loan growth for a time, but by

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[1]Credit-risk-concentrated loans include commercial and industrial loans, commercial real estate and construction loans, and loans secured by multifamily residential properties.

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1994, C&I loans had declined to 15 percent of the industry's total assets.

When C&I loans began to decline, many banks turned to commercial real estate loans and construction loans for new -- but high risk -- profit opportunities. In the mid- to late-1980s, growing concentrations in commercial real estate loans and construction loans offset shrinkage in C&I loans (see Table II). In 1976, commercial real estate loans and construction loans together comprised about five percent of the balance sheet. In ten years, the concentration increased to nearly eight percent of assets. It reached its highest level -- 11 percent -- in 1990. Banks were not the only providers of these loans. Savings and loan associations and other nonbank lenders also financed the speculative real estate development. Consequently, real estate markets in many regions became overbuilt, credit losses soared and commercial real estate loan demand diminished.

Loan growth since 1990 has been concentrated in loans where credit risk is more diversified (see Table II). Credit card, consumer and home mortgage loans extend relatively small and often collateralized balances to a relatively large number of borrowers. Failure of a single borrower to repay does not have a significant impact on a bank's earnings or capital. Most of the growth in "credit-risk-diversified" loans has come from home mortgages. Concentrations in home mortgage loans have nearly doubled since 1984, increasing from almost 8 percent of the industry's balance sheet to nearly 15 percent as of September 30, 1994. Credit card loans constitute 4.5 percent of assets and other "consumer" loans constitute 7.8 percent.

Beginning in 1990, the industry's risk profile began to change direction. Banks were able to take advantage of a widening difference between shorter- and longer-term interest rates to improve earnings while reducing credit risk. They shortened the average maturity of their liabilities and increased their concentrations of fixed-rate securities and residential mortgages. In effect, the industry replaced some of its credit risk with higher levels of interest-rate risk. Tables I and II show how the industry's asset composition has changed since the deregulation of deposit interest rates. In the early 1990s, the growth of investment securities held by banks -- primarily mortgage-backed instruments and U.S. Treasury securities -- accelerated. Market conditions also favored the growth of home mortgages, which have more than doubled since 1986, increasing from $223 billion at year-end 1986 to $550 billion as of September 30, 1994. While about 46 percent of these loans in the portfolios of banks carry adjustable rates, there is still interest-rate exposure, due to repricing lags, as well as caps that limit the amount by which the interest rates on the loans can increase.

In recent years, increased market volatility has made it re important for banks to manage risks other than credit risk, ch as interest-rate risk, prepayment risk, and foreign-exchange sk. Banks have responded to this challenge by devoting nsiderable resources to asset-liability management and other sk management systems.

The tools for managing these risks have expanded nsiderably over the past decade, particularly with the creasing use of off-balance-sheet instruments such as swaps, tions, and forward contracts. While smaller banks for the most rt still use on-balance-sheet instruments to manage risk, these f-balance-sheet instruments have become an integral part of sk management for most large banks.

Banks are not only end users of these swaps, options, and rwards. Several large banks are major dealers of over-the-unter instruments. This activity has provided an important urce of revenue and allowed these banks to respond to the needs their customers. Nevertheless, a series of recent losses has ised concerns about the potential risks of these investments.

Record bank failures in the 1980s and early 1990s were ickly replaced with record earnings as the economy improved in very favorable interest-rate environment. As Table IV shows, the last ten years, the industry achieved both its lowest nual return on assets (about 0.09 percent in 1987) and its ghest return on assets (1.20 percent in 1993) since the plementation of deposit insurance in 1933. Declining loan sses account for the wide swing in earnings. Declining loan-ss provisions have added roughly 25 basis points (pre-tax) to e industry's return on assets in each of the last three years. terest margins have improved steadily since 1934, but these provements have had relatively little impact compared with the duced burden of loan-loss provisions. Ten year growth in ninterest income has outstripped noninterest expense growth by narrow margin, providing a relatively small boost to the dustry's bottom line.

Bankers were not able to obtain expanded powers when the dustry was in trouble, as in the late 1980s, owing to concerns out adding new potential risks to an industry struggling with isting risks. Now, opponents may argue that expanded powers e not needed, given the record profits the industry has ported for the last three years. The tables suggest, however, at volatile swings in the health and performance of the dustry may result in part from constraints that limit ternatives for generating profits. The data show that credit sk, interest-rate risk and competition have all increased since e enactment of Glass-Steagall. While the earnings trend cently has been positive, the wide swings in past performance

indicate heightened uncertainty and increased risks in the industry.

International Developments

Global competitive pressures also present a compelling need to reconsider the Glass-Steagall prohibitions between investment and commercial banking. Domestic financial deregulation in major industrialized nations, the development of new financial instruments, and advances in communication and computer technologies have contributed to the rapid integration of international financial markets during the past two decades. These changes in the financial marketplace, both domestic and international, have led several major industrialized nations to change their laws governing financial institutions, with the goal of creating a more level competitive playing field. In particular, there has been a growing worldwide trend toward easing traditional distinctions among the three major segments of the financial services industry -- commercial banks, investment firms, and insurance companies.

It should be noted that commercial and investment banking have long been combined in countries with universal banking systems, such as Germany and most of western Europe. Universal banks have the authority to offer the full range of banking and financial services -- including securities underwriting and brokering of both government and corporate debt and equity -- within a single legal entity, the bank. Although some financial services are provided through subsidiaries, the bank or financial services holding company structure is virtually unknown in other countries.

In contrast to the universal banking structure allowed in Continental European countries, Canada, Japan and the United Kingdom traditionally maintained barriers and restrictions against combining commercial and investment banking activities. These restrictions have been largely removed by legislation in each of these countries. For example, British banks were permitted to join the stock exchange in 1986 and to acquire or develop investment banking subsidiaries. These affiliations are important to the ability of British banks to compete within the European Union's single market.

Canada amended its laws governing financial institutions in 1987 and 1992, removing many of the statutory barriers separating banks, trust companies, insurance companies and securities firms, to allow greater latitude in bank ownership of institutions in the other financial sectors. As a result, most of the major Canadian securities firms are now owned by banks. Additionally, banks were permitted to offer more services "in-house," and to set up networking arrangements through which their branches sell

the products of institutions in other sectors of the financial industry.

In 1992, Japan approved the "Financial System Reform Act," amending Japan's Securities and Exchange Law, and effectively removing the barriers between investment and commercial banking. By law since 1993, banks and securities companies have been allowed to enter each other's businesses through subsidiaries, although the establishment of securities subsidiaries by Japan's City Banks was delayed until July 1994. Additionally, the Ministry of Finance has elected to restrict the range of powers permissible for new subsidiaries of banks and securities firms. Thus, new trust banking subsidiaries are not permitted to manage pension funds and new securities subsidiaries of banks are only permitted to underwrite corporate bonds. In any event, Japan has had a moratorium on new equity offerings, with the exception of initial public offerings, since 1990.

As a result of these legislative changes in other countries, the United States stands alone among the 25 nations comprising the Organization for Economic Cooperation and Development (OECD) in continuing to impose domestic legal restrictions on affiliations between commercial banks and securities firms. Efforts to quantify the effect of these restrictions on the international competitiveness of U.S. banks are hampered by cross-border differences in accounting practices, tax laws, and other regulations governing financial institutions. Moreover, the data may be misleading due to currency fluctuations. Therefore, while we hesitate to provide any statistics regarding international competitiveness, some anecdotal evidence may be instructive.

Among the advantages of universal banking often cited are the cost savings derived from the ability to cross-sell a wider range of products and to offer highly-competitive products at a lower cost by subsidizing them with higher margins on less-competitive products. Universal banks may have a significant competitive advantage in customer loyalty through their ability to provide customers with all their financial services needs. Finally, universal banks have greater opportunities to spread risk and to smooth out income fluctuations in different areas of their business.

Not surprisingly, universal banks tend to be large and profitable institutions. The degree to which they dominate domestic market share varies according to the number, powers, and other structural characteristics of countries with universal banks. In Germany, for example, the four largest universal banks controlled less than 10 percent of total domestic bank assets in 1991; during the same year, the four largest Swiss banks controlled nearly 50 percent of domestic bank assets. These differences may be attributed to differences in their respective

domestic markets: German banks directly compete with approximately 200 regional banks, over 700 government-owned savings banks, and nearly 3,000 cooperative banks, many of which are also universal banks; in Switzerland, which has only about 600 institutions, most of the regional banks are small savings banks that specialize in mortgage lending.

There are several disadvantages inherent to universal banking as well. The one most often cited is the obvious potential for conflicts of interest among different areas of business. Another disadvantage is that capital markets are not as developed in countries with universal banking. It should be noted here that universal banks typically are permitted to own fairly sizeable equity positions in nonfinancial firms.

Banking and commerce links also exist in Japan, where banks are permitted to own equity investments in up to five percent in any one company. Studies comparing the German-style universal banking system and Japan's "keiretsu" form of industrial organization with the segmented U.S. banking system have concluded that the former may provide several important economic benefits. While these banking and commerce links no doubt have contributed to the industrial growth in these countries in the postwar era, they do raise serious concerns over concentration of power.

In Japan, these concerns are addressed through limitations on equity investments and the absence of bank personnel in the day-to-day management of nonfinancial firms. In contrast to Japan, where banks typically interfere only in cases of corporate distress, Germany not only permits banks to own shares, but also to serve on the supervisory boards of corporations and to exercise proxy rights over large blocks of shares through bank-managed portfolios. Other countries with universal banking have tended to curb bank control over industrial firms in recent years. Proposals to do so in Germany recently have been introduced as a result of the near-failure of several of Germany's nonfinancial firms.

These highly publicized cases were more of an embarrassment to Germany's major banks than a threat to their safety and soundness. These banks have been able to withstand losses due to their sheer size and strength, and to the very conservative accounting practices that allow equities to be carried at historical cost and allow banks to transfer portions of income to hidden reserves.

In fact, there are no cases in recent memory of a major bank failing in another country due to its securities activities or affiliations with commercial firms. The majority of banking problems in industrialized countries have been the result of traditional banking activities. For example, losses from

foreign-exchange trading have caused isolated cases of bank failures, while real estate lending in "boom" years led to system-wide banking crises in the United Kingdom, most of the Scandinavian countries and Japan, in addition to the well-known problems encountered by U.S. banks and savings and loan institutions.

If other problems have occurred, and no doubt there have been some, they have been dealt with quietly and effectively, without recourse to deposit insurance funds. This is largely due to the differences in the supervisory structure of countries that permit such affiliations, and to differences in failure-resolution methods and the role of deposit insurance. For example, while deposit insurance coverage is roughly comparable between the United States and Japan, the private sector plays a larger role in the operation of deposit insurance in many other countries. Consequently, the direct link to the government's "full faith and credit" is less explicit than in the United States. Major banks in other countries also are called upon more often to help in "bailouts" of other banks, voluntarily or otherwise, due to a traditionally close relationship with the central bank and more highly concentrated banking systems.

Given the greater potential for conflicts of interest between insured and uninsured functions, the governmental nature of deposit insurance in the United States, and the more dynamic and diverse financial marketplace in the United States, the universal banking model does not seem to be as suited to the current U.S. environment as other Models with which the United States has experience.

TABLE I-A

Composition of Assets for Insured Commercial Banks 1934-1994

($ Millions)

Classification of Assets According to Risk Categories Dollar values					(Data are for all insured commercial banks)				
	Capital Market & Interest Rate Risk		Credit Risk & Interest Rate Risk						
Year	Cash & Other Earning Assets	Investment Securities	Credit Risk Diversified[1] Total Consumer	Credit Risk Concentrated[2] (Loans, Total – Total Consum.)	Residual– All Other Assets	Loan Loss Reserves[3]	Total Assets	Asset Growth	Adjusted Gross Assets (Assets + reserve – residual)
09/94	622,991	836,980	1,010,866	1,269,712	235,140	52,443	3,923,246	5.86%	3,740,549
1993	545,658	836,562	934,676	1,215,139	226,544	52,631	3,705,948	5.72%	3,532,035
1992	537,076	772,875	848,753	1,183,105	218,189	54,478	3,505,520	2.18%	3,341,809
1991	520,678	691,384	822,550	1,230,174	220,966	55,144	3,430,608	1.21%	3,264,786
1990	512,598	604,622	804,125	1,306,039	217,612	55,532	3,389,464	2.73%	3,227,384
1989	539,475	558,639	752,038	1,306,157	196,795	53,743	3,299,361	5.38%	3,156,309
1988	518,778	535,995	679,736	1,252,640	190,312	46,666	3,130,795	4.36%	2,987,149
1987	521,473	520,713	614,408	1,214,767	178,479	49,890	2,999,949	2.01%	2,871,360
1986	561,434	484,865	558,293	1,198,145	166,862	28,900	2,940,699	7.69%	2,802,736
1985	514,406	439,407	507,752	1,123,038	169,332	23,262	2,730,672	8.84%	2,584,602
1984	463,055	385,549	448,550	1,060,051	170,370	18,705	2,508,870	7.12%	2,357,205
1983	452,388	424,295	391,948	924,832	164,110	15,472	2,342,101	6.78%	2,193,463
1982	457,143	366,676	357,452	866,832	158,439	13,203	2,193,339	8.10%	2,048,103
1981	431,358	339,337	347,356	784,180	138,166	11,415	2,028,982	9.40%	1,902,231
1980	411,646	324,058	334,241	682,220	112,574	10,053	1,854,686	9.63%	1,752,165
1979	377,615	284,092	329,469	615,234	94,561	9,182	1,691,789	12.19%	1,606,410
1978	330,043	269,120	289,827	551,108	75,794	7,956	1,507,936	12.58%	1,440,098
1977	299,232	258,125	238,017	491,688	59,006	6,692	1,339,376	13.27%	1,287,062
1976	257,540	246,513	199,986	433,029	51,531	6,187	1,182,412	8.81%	1,137,068
1975	232,085	226,024	183,829	406,389	47,002	8,655	1,086,674	4.77%	1,048,327
1974	225,228	188,892	178,266	405,789	47,399	8,377	1,037,197	26.43%	998,175
1973	159,974	179,401	168,179	287,018	33,357	7,529	820,400	12.24%	794,572
1972	142,607	178,459	144,473	244,429	27,558	6,624	730,902	15.36%	709,968
1971	123,642	163,681	122,678	205,548	24,176	6,151	633,573	11.12%	615,549
1970	114,664	141,370	108,221	189,965	21,937	5,999	570,158	8.68%	554,220
1969	102,229	122,019	104,424	182,328	19,531	5,886	524,645	4.90%	511,000
1968	89,793	135,202	99,551	165,089	15,740	5,215	500,160	10.99%	489,635
1967	81,453	123,241	88,790	148,699	13,196	4,732	450,647	11.85%	442,183
1966	71,110	104,271	82,646	137,660	11,549	4,337	402,899	7.33%	395,687
1965	62,501	103,651	77,657	125,405	10,192	4,011	375,394	8.77%	369,213
1964	60,033	100,960	68,554	110,095	9,042	3,553	345,130	10.69%	339,641
1963	50,445	97,472	60,777	98,151	7,939	2,995	311,790	5.34%	306,846
1962	53,799	94,912	53,892	88,826	7,248	2,694	295,983	6.71%	291,429
1961	56,181	89,662	48,970	78,444	6,724	2,606	277,374	8.21%	273,257
1960	51,902	81,020	46,665	73,213	5,879	2,356	256,322	5.30%	252,800
1959	49,211	78,582	44,381	68,486	4,934	2,172	243,422	2.50%	240,660
1958	48,792	86,056	39,100	60,986	4,494	1,955	237,474	7.20%	234,935
1957	48,219	75,330	37,190	58,387	4,184	1,776	221,534	2.49%	219,125
1956	48,444	73,947	35,665	56,040	3,612	1,562	216,146	3.35%	214,096
1955	46,560	77,240	32,875	50,753	2,984	1,268	209,145	4.27%	207,428
1954	43,235	84,142	28,699	42,713	2,871	1,071	200,589	4.99%	198,789
1953	44,478	76,851	27,156	41,071	2,466	961	191,062	2.35%	189,557
1952	44,299	76,280	24,638	40,091	2,278	904	186,682	5.20%	185,308
1951	44,242	73,673	21,481	36,704	2,164	814	177,449	6.39%	176,099
1950	39,865	73,198	20,311	32,170	1,921	673	166,792	7.39%	165,544
1949	35,222	75,824	16,520	26,527	1,774	548	155,319	2.07%	154,093
1948	38,097	70,339	14,719	27,669	1,748	409	152,163	−0.40%	150,824
1947	36,936	76,712	12,471	25,121	1,532	NA	152,773	3.67%	151,240
1946	33,704	81,469	9,089	21,651	1,452	NA	147,365	−6.48%	145,913
1945	34,303	96,066	5,693	20,076	1,444	NA	157,582	17.06%	156,138
1944	29,746	82,053	5,045	16,310	1,459	NA	134,613	19.93%	133,154
1943	27,191	64,678	5,072	13,772	1,533	NA	112,246	17.59%	110,713
1942	27,593	47,344	5,534	13,373	1,615	NA	95,459	24.25%	93,844
1941	25,793	28,032	3,209	18,053	1,740	NA	76,827	8.64%	75,087
1940	26,291	24,163	2,883	15,515	1,868	NA	70,720	11.99%	68,852
1939	21,876	22,428	2,597	14,269	1,977	NA	63,147	11.17%	61,170
1938	17,176	21,451	2,417	13,607	2,149	NA	56,800	4.77%	54,651
1937	14,931	20,476	3,139	13,611	2,055	NA	54,212	−3.56%	52,157
1936	15,730	22,307	2,959	13,006	2,208	NA	56,210	10.38%	54,002
1935	13,851	20,116	2,835	11,884	2,240	NA	50,926	9.64%	48,686
1934	11,202	18,172	2,836	11,777	2,461	NA	46,448	--	43,988

Footnotes are at the end of the tables

Source: Historical Statistics on Banking, 1934–1993

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TABLE I-B

Composition of Assets for Insured Commercial Banks 1934-1994

(Percentages)

Classification of Assets According to Risk Categories Percent of adjusted gross assets (Data are for all insured commercial banks)								
	Capital Market & Interest Rate Risk		Credit Risk & Interest Rate Risk					
Year	Cash & Other Earning Assets	Investment Securities	Credit Risk Diversified Total Consumer	Credit Risk Concentrated (Loans, Total – Total Consum.)	Adjusted Gross Assets (Assets + reserve – residual)	Residual– All Other Assets	Loan Loss Reserves	Adjusted Gross Assets (Assets + reserve – residual)
09/94	16.66%	22.38%	27.02%	33.94%	100.00%	6.29%	1.40%	107.69%
1993	15.45%	23.68%	26.46%	34.40%	100.00%	6.41%	1.49%	107.90%
1992	16.07%	23.13%	25.40%	35.40%	100.00%	6.53%	1.63%	108.16%
1991	15.95%	21.18%	25.19%	37.68%	100.00%	6.77%	1.69%	108.46%
1990	15.88%	18.73%	24.92%	40.47%	100.00%	6.74%	1.72%	108.46%
1989	17.09%	17.70%	23.83%	41.38%	100.00%	6.23%	1.70%	107.94%
1988	17.37%	17.94%	22.76%	41.93%	100.00%	6.37%	1.56%	107.93%
1987	18.16%	18.13%	21.40%	42.31%	100.00%	6.22%	1.74%	107.95%
1986	20.03%	17.30%	19.92%	42.75%	100.00%	5.95%	1.03%	106.98%
1985	19.90%	17.00%	19.65%	43.45%	100.00%	6.55%	0.90%	107.45%
1984	19.64%	16.36%	19.03%	44.97%	100.00%	7.23%	0.79%	108.02%
1983	20.62%	19.34%	17.87%	42.16%	100.00%	7.48%	0.71%	108.19%
1982	22.32%	17.90%	17.45%	42.32%	100.00%	7.74%	0.64%	108.38%
1981	22.68%	17.84%	18.26%	41.22%	100.00%	7.26%	0.60%	107.86%
1980	23.49%	18.49%	19.08%	38.94%	100.00%	6.42%	0.57%	107.00%
1979	23.51%	17.68%	20.51%	38.30%	100.00%	5.89%	0.57%	106.46%
1978	22.92%	18.69%	20.13%	38.27%	100.00%	5.26%	0.55%	105.82%
1977	23.25%	20.06%	18.49%	38.20%	100.00%	4.58%	0.52%	105.10%
1976	22.65%	21.68%	17.59%	38.08%	100.00%	4.53%	0.54%	105.08%
1975	22.14%	21.56%	17.54%	38.77%	100.00%	4.48%	0.83%	105.31%
1974	22.56%	18.92%	17.86%	40.65%	100.00%	4.75%	0.84%	105.59%
1973	20.13%	22.58%	21.17%	36.12%	100.00%	4.20%	0.95%	105.15%
1972	20.09%	25.14%	20.35%	34.43%	100.00%	3.88%	0.93%	104.81%
1971	20.09%	26.59%	19.93%	33.39%	100.00%	3.93%	1.00%	104.93%
1970	20.69%	25.51%	19.53%	34.28%	100.00%	3.96%	1.08%	105.04%
1969	20.01%	23.88%	20.44%	35.68%	100.00%	3.82%	1.15%	104.97%
1968	18.34%	27.61%	20.33%	33.72%	100.00%	3.21%	1.07%	104.28%
1967	18.42%	27.87%	20.08%	33.63%	100.00%	2.98%	1.07%	104.05%
1966	17.97%	26.35%	20.89%	34.79%	100.00%	2.92%	1.10%	104.01%
1965	16.93%	28.07%	21.03%	33.97%	100.00%	2.76%	1.09%	103.85%
1964	17.68%	29.73%	20.18%	32.42%	100.00%	2.66%	1.05%	103.71%
1963	16.44%	31.77%	19.81%	31.99%	100.00%	2.59%	0.98%	103.56%
1962	18.46%	32.57%	18.49%	30.48%	100.00%	2.49%	0.92%	103.41%
1961	20.56%	32.81%	17.92%	28.71%	100.00%	2.46%	0.95%	103.41%
1960	20.53%	32.05%	18.46%	28.96%	100.00%	2.33%	0.93%	103.26%
1959	20.45%	32.65%	18.44%	28.46%	100.00%	2.05%	0.90%	102.95%
1958	20.77%	36.63%	16.64%	25.96%	100.00%	1.91%	0.83%	102.74%
1957	22.01%	34.38%	16.97%	26.65%	100.00%	1.91%	0.81%	102.72%
1956	22.63%	34.54%	16.66%	26.18%	100.00%	1.69%	0.73%	102.42%
1955	22.45%	37.24%	15.85%	24.47%	100.00%	1.44%	0.61%	102.05%
1954	21.75%	42.33%	14.44%	21.49%	100.00%	1.44%	0.54%	101.98%
1953	23.46%	40.54%	14.33%	21.67%	100.00%	1.30%	0.51%	101.81%
1952	23.91%	41.16%	13.30%	21.63%	100.00%	1.23%	0.49%	101.72%
1951	25.12%	41.84%	12.20%	20.84%	100.00%	1.23%	0.46%	101.69%
1950	24.08%	44.22%	12.27%	19.43%	100.00%	1.16%	0.41%	101.57%
1949	22.86%	49.21%	10.72%	17.21%	100.00%	1.15%	0.36%	101.51%
1948	25.26%	46.64%	9.76%	18.35%	100.00%	1.16%	0.27%	101.43%
1947	24.42%	50.72%	8.25%	16.61%	100.00%	1.01%	NA	101.01%
1946	23.10%	55.83%	6.23%	14.84%	100.00%	1.00%	NA	101.00%
1945	21.97%	61.53%	3.65%	12.86%	100.00%	0.92%	NA	100.92%
1944	22.34%	61.62%	3.79%	12.25%	100.00%	1.10%	NA	101.10%
1943	24.56%	58.42%	4.58%	12.44%	100.00%	1.38%	NA	101.38%
1942	29.40%	50.45%	5.90%	14.25%	100.00%	1.72%	NA	101.72%
1941	34.35%	37.33%	4.27%	24.04%	100.00%	2.32%	NA	102.32%
1940	38.18%	35.09%	4.19%	22.53%	100.00%	2.71%	NA	102.71%
1939	35.76%	36.67%	4.25%	23.33%	100.00%	3.23%	NA	103.23%
1938	31.43%	39.25%	4.42%	24.90%	100.00%	3.93%	NA	103.93%
1937	28.63%	39.26%	6.02%	26.10%	100.00%	3.94%	NA	103.94%
1936	29.13%	41.31%	5.48%	24.08%	100.00%	4.09%	NA	104.09%
1935	28.45%	41.32%	5.82%	24.41%	100.00%	4.60%	NA	104.60%
1934	25.47%	41.31%	6.45%	26.77%	100.00%	5.59%	NA	105.59%

Source: Historical Statistics on Banking, 1934–1993

TABLE II-A

Composition of Loans for Insured Commercial Banks 1934-1994

($ Millions)

(Data are for all insured commercial banks)

	Credit Risk Diversified[1]				Credit Risk Concentrated[2]				
						Real Estate--------			
End	Credit Cards & Related Plans	All Other	1-4 Family Residential Properties	Credit Risk Diversified Total	Commercial & Industrial	Construction and Land Developmen	Nonfarm Non-Residential	All Other	Credit Risk Concen. Total
09/94	169,828	291,022	550,016	1,010,866	575,426	64,108	278,649	351,529	1,269,712
1993	153,493	265,494	515,689	934,676	538,952	66,419	267,657	342,111	1,215,139
1992	135,900	249,406	463,447	848,753	536,169	78,626	257,746	310,564	1,183,105
1991	139,097	252,758	430,695	822,550	558,862	102,645	249,581	319,086	1,230,174
1990	133,593	269,907	400,625	804,125	614,984	126,160	238,220	326,675	1,306,039
1989	131,460	269,735	350,843	752,038	618,468	135,987	215,382	336,320	1,306,157
1988	117,236	260,733	301,767	679,736	600,213	128,441	189,036	334,950	1,252,640
1987	102,911	248,276	263,222	614,408	589,036	119,911	167,538	338,282	1,214,767
1986	91,857	243,846	222,590	558,293	600,454	106,744	140,362	350,584	1,198,145
1985	78,446	230,555	198,751	507,752	577,359	89,234	113,450	342,995	1,123,038
1984	61,196	205,715	181,639	448,550	565,252	76,140	96,133	322,525	1,060,051
1983	45,242	179,367	167,339	391,948	524,749	60,577	81,431	258,075	924,832
1982	36,728	162,251	158,473	357,452	504,125	52,305	72,072	238,330	866,832
1981	32,816	159,569	154,971	347,356	455,246	44,946	67,257	216,731	784,180
1980	29,872	157,504	146,865	334,241	390,973	36,591	63,875	190,781	682,220
1979	29,934	162,759	136,776	329,469	351,066	32,720	59,587	171,861	615,234
1978	24,438	147,445	117,944	289,827	307,592	27,024	53,604	162,888	551,108
1977	18,461	122,791	96,765	238,017	197,092	21,395	47,803	225,398	491,688
1976	14,428	104,478	81,080	199,986	178,751	17,273	41,253	195,752	433,029
1975	12,377	94,433	77,019	183,829	175,923	NA	46,882	183,584	406,389
1974	11,138	92,576	74,552	178,266	184,217	NA	43,577	177,995	405,789
1973	9,141	91,242	67,796	168,179	158,688	NA	38,642	89,688	287,018
1972	7,224	80,406	56,843	144,473	132,498	NA	31,715	80,216	244,429
1971	5,988	68,809	47,881	122,678	118,401	NA	26,278	60,869	205,548
1970	5,152	60,852	42,217	108,221	112,268	NA	23,239	54,458	189,965
1969	3,722	59,633	41,068	104,424	108,394	NA	22,053	51,881	182,328
1968	2,110	56,297	41,144	99,551	98,143	NA	20,449	46,497	165,089
1967	1,350	50,070	37,370	88,790	88,182	NA	17,885	42,632	148,699
1966	NA	47,986	34,660	82,646	80,394	NA	16,330	40,936	137,660
1965	NA	45,497	32,159	77,657	71,235	NA	14,346	39,823	125,405
1964	NA	39,815	28,739	68,554	60,040	NA	12,378	37,677	110,095
1963	NA	34,532	26,245	60,777	52,702	NA	10,540	34,909	98,151
1962	NA	30,524	23,368	53,892	48,668	NA	8,939	31,219	88,826
1961	NA	27,820	21,150	48,970	45,157	NA	7,449	25,839	78,444
1960	NA	26,377	20,288	46,665	43,132	NA	6,775	23,305	73,213
1959	NA	24,134	20,247	44,381	40,195	NA	6,214	22,077	68,486
1958	NA	20,680	18,420	39,100	40,457	NA	5,394	15,135	60,986
1957	NA	20,200	16,990	37,190	40,546	NA	4,766	13,076	58,387
1956	NA	18,829	16,836	35,665	38,707	NA	4,331	13,002	56,040
1955	NA	17,160	15,715	32,875	33,210	NA	3,773	13,770	50,753
1954	NA	14,720	13,979	28,699	26,823	NA	3,229	12,661	42,713
1953	NA	14,412	12,744	27,156	27,158	NA	2,806	11,108	41,071
1952	NA	12,642	11,996	24,638	27,816	NA	2,583	9,691	40,091
1951	NA	10,399	11,081	21,481	25,788	NA	2,423	8,493	36,704
1950	NA	10,061	10,250	20,311	21,808	NA	2,219	8,143	32,170
1949	NA	8,007	8,513	16,520	16,939	NA	2,014	7,573	26,527
1948	NA	6,806	7,913	14,719	18,765	NA	1,911	6,993	27,669
1947	NA	5,655	6,816	12,471	18,015	NA	1,661	5,445	25,121
1946	NA	4,031	5,058	9,089	14,019	NA	1,365	6,267	21,651
1945	NA	2,361	3,332	5,693	9,462	NA	840	9,774	20,076
1944	NA	1,888	3,157	5,045	7,921	NA	738	7,651	16,310
1943	NA	1,868	3,204	5,072	7,778	NA	786	5,208	13,772
1942	NA	2,270	3,263	5,534	7,758	NA	907	4,709	13,373
1941	NA	NA	3,209	3,209	9,215	NA	1,031	7,807	18,053
1940	NA	NA	2,883	2,883	7,179	NA	1,044	7,292	15,515
1939	NA	NA	2,597	2,597	6,331	NA	1,006	6,931	14,269
1938	NA	NA	2,417	2,417	5,633	NA	923	7,051	13,607
1937	NA	NA	3,139	3,139	NA	NA	NA	13,611	13,611
1936	NA	NA	2,959	2,959	NA	NA	NA	13,006	13,006
1935	NA	NA	2,835	2,835	NA	NA	NA	11,884	11,884
1934	NA	NA	2,836	2,836	NA	NA	NA	11,777	11,777

Source: Historical Statistics on Banking, 1934-1993

TABLE II-B

Composition of Loans for Insured Commercial Banks 1934-1994

(Percentages)

(Data are for all insured commercial banks)

	Credit Risk Diversified[1]				Credit Risk Concentrated[2]				
						Real Estate-------			Credit
	Credit Cards		1-4 Family	Credit Risk		Construction	Nonfarm		Risk
	& Related	All	Residential	Diversified	Commercial	and Land	Non-	All	Concen.
End	Plans	Other	Properties	Total	& Industrial	Development	Residential	Other	Total
09/94	4.54%	7.78%	14.70%	27.02%	15.38%	1.71%	7.45%	9.40%	33.94%
1993	4.35%	7.52%	14.60%	26.46%	15.26%	1.88%	7.58%	9.69%	34.40%
1992	4.07%	7.46%	13.87%	25.40%	16.04%	2.35%	7.71%	9.29%	35.40%
1991	4.26%	7.74%	13.19%	25.19%	17.12%	3.14%	7.64%	9.77%	37.68%
1990	4.14%	8.36%	12.41%	24.92%	19.06%	3.91%	7.38%	10.12%	40.47%
1989	4.16%	8.55%	11.12%	23.83%	19.59%	4.31%	6.82%	10.66%	41.38%
1988	3.92%	8.73%	10.10%	22.76%	20.09%	4.30%	6.33%	11.21%	41.93%
1987	3.58%	8.65%	9.17%	21.40%	20.51%	4.18%	5.83%	11.78%	42.31%
1986	3.28%	8.70%	7.94%	19.92%	21.42%	3.81%	5.01%	12.51%	42.75%
1985	3.04%	8.92%	7.69%	19.65%	22.34%	3.45%	4.39%	13.27%	43.45%
1984	2.60%	8.73%	7.71%	19.03%	23.98%	3.23%	4.08%	13.68%	44.97%
1983	2.06%	8.18%	7.63%	17.87%	23.92%	2.76%	3.71%	11.77%	42.16%
1982	1.79%	7.92%	7.74%	17.45%	24.61%	2.55%	3.52%	11.64%	42.32%
1981	1.73%	8.39%	8.15%	18.26%	23.93%	2.36%	3.54%	11.39%	41.22%
1980	1.70%	8.99%	8.38%	19.08%	22.31%	2.09%	3.65%	10.89%	38.94%
1979	1.86%	10.13%	8.51%	20.51%	21.85%	2.04%	3.71%	10.70%	38.30%
1978	1.70%	10.24%	8.19%	20.13%	21.36%	1.88%	3.72%	11.31%	38.27%
1977	1.43%	9.54%	7.52%	18.49%	15.31%	1.66%	3.71%	17.51%	38.20%
1976	1.27%	9.19%	7.13%	17.59%	15.72%	1.52%	3.63%	17.22%	38.08%
1975	1.18%	9.01%	7.35%	17.54%	16.78%	NA	4.47%	17.51%	38.77%
1974	1.12%	9.27%	7.47%	17.86%	18.46%	NA	4.37%	17.83%	40.65%
1973	1.15%	11.48%	8.53%	21.17%	19.97%	NA	4.86%	11.29%	36.12%
1972	1.02%	11.33%	8.01%	20.35%	18.66%	NA	4.47%	11.30%	34.43%
1971	0.97%	11.18%	7.78%	19.93%	19.24%	NA	4.27%	9.89%	33.39%
1970	0.93%	10.98%	7.62%	19.53%	20.26%	NA	4.19%	9.83%	34.28%
1969	0.73%	11.67%	8.04%	20.44%	21.21%	NA	4.32%	10.15%	35.68%
1968	0.43%	11.50%	8.40%	20.33%	20.04%	NA	4.18%	9.50%	33.72%
1967	0.31%	11.32%	8.45%	20.08%	19.94%	NA	4.04%	9.64%	33.63%
1966	NA	12.13%	8.76%	20.89%	20.32%	NA	4.13%	10.35%	34.79%
1965	NA	12.32%	8.71%	21.03%	19.29%	NA	3.89%	10.79%	33.97%
1964	NA	11.72%	8.46%	20.18%	17.68%	NA	3.64%	11.09%	32.42%
1963	NA	11.25%	8.55%	19.81%	17.18%	NA	3.43%	11.38%	31.99%
1962	NA	10.47%	8.02%	18.49%	16.70%	NA	3.07%	10.71%	30.48%
1961	NA	10.18%	7.74%	17.92%	16.53%	NA	2.73%	9.46%	28.71%
1960	NA	10.43%	8.03%	18.46%	17.06%	NA	2.68%	9.22%	28.96%
1959	NA	10.03%	8.41%	18.44%	16.70%	NA	2.58%	9.17%	28.46%
1958	NA	8.80%	7.84%	16.64%	17.22%	NA	2.30%	6.44%	25.96%
1957	NA	9.22%	7.75%	16.97%	18.50%	NA	2.17%	5.97%	26.65%
1956	NA	8.79%	7.86%	16.66%	18.08%	NA	2.02%	6.07%	26.18%
1955	NA	8.27%	7.58%	15.85%	16.01%	NA	1.82%	6.64%	24.47%
1954	NA	7.40%	7.03%	14.44%	13.49%	NA	1.62%	6.37%	21.49%
1953	NA	7.60%	6.72%	14.33%	14.33%	NA	1.48%	5.86%	21.67%
1952	NA	6.82%	6.47%	13.30%	15.01%	NA	1.39%	5.23%	21.63%
1951	NA	5.91%	6.29%	12.20%	14.64%	NA	1.38%	4.82%	20.84%
1950	NA	6.08%	6.19%	12.27%	13.17%	NA	1.34%	4.92%	19.43%
1949	NA	5.20%	5.52%	10.72%	10.99%	NA	1.31%	4.91%	17.21%
1948	NA	4.51%	5.25%	9.76%	12.44%	NA	1.27%	4.64%	18.35%
1947	NA	3.74%	4.51%	8.25%	11.91%	NA	1.10%	3.60%	16.61%
1946	NA	2.76%	3.47%	6.23%	9.61%	NA	0.94%	4.29%	14.84%
1945	NA	1.51%	2.13%	3.65%	6.06%	NA	0.54%	6.26%	12.86%
1944	NA	1.42%	2.37%	3.79%	5.95%	NA	0.55%	5.75%	12.25%
1943	NA	1.69%	2.89%	4.58%	7.03%	NA	0.71%	4.70%	12.44%
1942	NA	2.42%	3.48%	5.90%	8.27%	NA	0.97%	5.02%	14.25%
1941	NA	NA	4.27%	4.27%	12.27%	NA	1.37%	10.40%	24.04%
1940	NA	NA	4.19%	4.19%	10.43%	NA	1.52%	10.59%	22.53%
1939	NA	NA	4.25%	4.25%	10.35%	NA	1.64%	11.33%	23.33%
1938	NA	NA	4.42%	4.42%	10.31%	NA	1.69%	12.90%	24.90%
1937	NA	NA	6.02%	6.02%	NA	NA	NA	26.10%	26.10%
1936	NA	NA	5.48%	5.48%	NA	NA	NA	24.08%	24.08%
1935	NA	NA	5.82%	5.82%	NA	NA	NA	24.41%	24.41%
1934	NA	NA	6.45%	6.45%	NA	NA	NA	26.77%	26.77%

Source: Historical Statistics on Banking, 1934–1993

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TABLE III

INCOME AND EXPENSES OF INSURED COMMERCIAL BANKS 1934-1994

($ Millions)

Income Components, % of average assets									(Data are for all insured commercial banks)		
Year	Number of Banks	Total Interest Income	% of Average Assets	Total Interest Expense	% of Average Assets	Net Interest Income	% of Average Assets	Total Nonint Income	% of Average Assets	Total Nonint Expense	% of Average Assets
09/94	10,592	189,128	6.59%	80,305	2.80%	108,823	3.79%	56,534	1.97%	105,875	3.69%
1993	10,960	245,158	6.80%	105,780	2.93%	139,378	3.87%	74,962	2.08%	139,585	3.87%
1992	11,466	255,228	7.36%	121,812	3.51%	133,416	3.85%	65,614	1.89%	130,917	3.77%
1991	11,927	289,217	8.48%	167,308	4.91%	121,909	3.58%	59,736	1.75%	124,790	3.66%
1990	12,347	320,476	9.58%	204,952	6.13%	115,524	3.45%	54,899	1.64%	115,768	3.46%
1989	12,715	317,371	9.87%	205,142	6.38%	112,229	3.49%	50,916	1.58%	108,121	3.36%
1988	11,137	272,277	8.88%	165,028	5.38%	107,249	3.50%	44,953	1.47%	101,330	3.31%
1987	13,723	244,839	8.24%	144,953	4.88%	99,886	3.36%	41,481	1.40%	97,244	3.27%
1986	14,210	237,765	8.38%	142,829	5.04%	94,936	3.35%	35,877	1.27%	90,250	3.18%
1985	14,417	248,220	9.47%	157,323	6.01%	90,898	3.47%	31,054	1.19%	82,365	3.14%
1984	14,496	250,350	10.32%	169,084	6.97%	81,266	3.35%	26,515	1.09%	73,818	3.04%
1983	14,469	217,226	9.58%	143,887	6.35%	73,339	3.23%	23,269	1.03%	66,910	2.95%
1982	14,451	238,315	11.29%	169,343	8.02%	68,972	3.27%	20,176	0.96%	61,561	2.92%
1981	14,414	231,271	11.91%	169,840	8.75%	61,431	3.16%	17,527	0.90%	53,658	2.76%
1980	14,434	176,420	9.95%	120,123	6.77%	56,297	3.17%	14,348	0.81%	46,662	2.63%
1979	14,364	138,901	8.68%	87,913	5.50%	50,988	3.19%	11,381	0.71%	40,693	2.54%
1978	14,391	103,957	7.30%	59,383	4.17%	44,574	3.13%	9,625	0.68%	35,572	2.50%
1977	14,411	82,252	6.52%	44,565	3.53%	37,687	2.99%	8,106	0.64%	30,925	2.45%
1976	14,410	73,033	6.44%	39,328	3.47%	33,705	2.97%	7,631	0.67%	27,731	2.44%
1975	14,384	57,915	5.45%	30,240	2.85%	27,675	2.61%	8,643	0.81%	23,729	2.23%
1974	14,230	61,218	6.59%	35,070	3.78%	26,148	2.82%	6,926	0.75%	21,546	2.32%
1973	13,976	47,034	6.06%	24,489	3.16%	22,545	2.91%	6,000	0.77%	18,572	2.39%
1972	13,733	35,030	5.13%	15,603	2.29%	19,427	2.85%	5,220	0.77%	16,423	2.41%
1971	13,612	31,628	5.25%	13,603	2.26%	18,025	2.99%	4,747	0.79%	15,191	2.52%
1970	13,511	30,513	5.57%	12,456	2.28%	18,057	3.30%	4,202	0.77%	14,429	2.64%
1969	13,473	27,285	5.32%	11,532	2.25%	15,753	3.07%	3,520	0.69%	12,024	2.35%
1968	13,487	22,501	4.73%	9,315	1.96%	13,186	2.77%	2,975	0.63%	10,140	2.13%
1967	13,514	19,152	4.49%	7,734	1.81%	11,418	2.68%	2,626	0.62%	8,903	2.09%
1966	13,538	17,136	4.40%	6,628	1.70%	10,508	2.70%	2,373	0.61%	8,002	2.06%
1965	13,547	14,715	4.08%	5,316	1.48%	9,399	2.61%	2,114	0.59%	7,298	2.03%
1964	13,493	13,111	3.99%	4,241	1.29%	8,870	2.70%	1,925	0.59%	6,780	2.06%
1963	13,291	11,770	3.87%	3,574	1.18%	8,196	2.70%	1,750	0.58%	6,206	2.04%
1962	13,124	10,570	3.69%	2,911	1.02%	7,659	2.67%	1,660	0.58%	5,746	2.00%
1961	13,115	9,540	3.58%	2,146	0.80%	7,394	2.77%	1,550	0.58%	5,383	2.02%
1960	13,126	9,176	3.67%	1,874	0.75%	7,302	2.92%	1,578	0.63%	5,142	2.06%
1959	13,114	8,247	3.43%	1,662	0.69%	6,585	2.74%	1,456	0.61%	4,853	2.02%
1958	13,124	7,187	3.13%	1,407	0.61%	5,780	2.52%	1,334	0.58%	4,287	1.87%
1957	13,165	6,818	3.12%	1,193	0.55%	5,625	2.57%	1,244	0.57%	4,047	1.85%
1956	13,218	6,126	2.88%	854	0.40%	5,272	2.48%	1,122	0.53%	3,725	1.75%
1955	13,237	5,381	2.63%	704	0.34%	4,677	2.28%	1,020	0.50%	3,370	1.64%
1954	13,323	4,861	2.48%	630	0.32%	4,231	2.16%	931	0.48%	3,087	1.58%
1953	13,432	4,660	2.47%	562	0.30%	4,098	2.17%	837	0.44%	2,902	1.54%
1952	13,439	4,160	2.28%	483	0.27%	3,677	2.02%	787	0.43%	2,603	1.43%
1951	13,455	3,658	2.13%	399	0.23%	3,259	1.89%	755	0.44%	2,345	1.36%
1950	13,446	3,249	2.02%	352	0.22%	2,897	1.80%	700	0.43%	2,120	1.32%
1949	13,436	2,975	1.94%	337	0.22%	2,638	1.72%	651	0.42%	1,971	1.28%
1948	13,419	2,798	1.84%	325	0.21%	2,473	1.62%	642	0.42%	1,852	1.21%
1947	13,403	2,541	1.69%	307	0.20%	2,234	1.49%	602	0.40%	1,687	1.12%
1946	13,359	2,346	1.54%	279	0.18%	2,067	1.36%	576	0.38%	1,505	0.99%
1945	13,302	2,027	1.39%	248	0.17%	1,779	1.22%	578	0.40%	1,309	0.90%
1944	13,268	1,788	1.45%	202	0.16%	1,586	1.28%	519	0.42%	1,199	0.97%
1943	13,274	1,567	1.51%	179	0.17%	1,388	1.34%	484	0.47%	1,118	1.08%
1942	13,347	1,427	1.66%	190	0.22%	1,237	1.44%	420	0.49%	1,085	1.26%
1941	13,430	1,357	1.84%	208	0.28%	1,149	1.56%	446	0.60%	1,102	1.49%
1940	13,442	1,268	1.89%	219	0.33%	1,049	1.57%	436	0.65%	1,033	1.54%
1939	13,538	1,249	2.08%	234	0.39%	1,015	1.69%	423	0.71%	992	1.65%
1938	13,661	1,237	2.23%	250	0.45%	987	1.78%	409	0.74%	968	1.74%
1937	13,797	1,282	2.32%	261	0.47%	1,021	1.85%	410	0.74%	958	1.74%
1936	13,973	1,237	2.31%	273	0.51%	964	1.80%	505	0.94%	950	1.77%
1935	14,125	1,191	2.45%	298	0.61%	893	1.83%	583	1.20%	854	1.75%
1934	14,146	1,241	--	328	--	913	--	470	--	863	--

Note: All percentages for 9/94 have been annualized (x1.33), dollar amounts have not been annualized

Source: Statistics on Banking, 1934–1993

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TABLE III, cont.

INCOME AND EXPENSES OF INSURED COMMERCIAL BANKS 1934-1994, cont.

($ Millions)

Income Components, % of average assets							(Data are for all insured commercial banks)					
Year	Provision for Loan & Lease Losses	% of Average Assets	Pre-tax Net Operati Income	% of Average Assets	Securiti Gains (Losses	% of Average Assets	Applicabl Income Taxes	% of Average Assets	Net Extra-ordin: Items	% of Average Assets	Net Income	% of Average Assets
09/94	8,027	0.28%	51,454	1.79%	343	0.01%	17,786	0.62%	(29)	-0.00%	33,982	1.18%
1993	16,588	0.46%	58,167	1.61%	3,064	0.08%	19,892	0.55%	2,090	0.06%	43,429	1.20%
1992	26,046	0.75%	42,067	1.21%	4,007	0.12%	14,486	0.42%	410	0.01%	31,998	0.92%
1991	34,313	1.01%	22,542	0.66%	2,972	0.09%	8,265	0.24%	687	0.02%	17,936	0.53%
1990	32,088	0.96%	22,567	0.67%	481	0.01%	7,704	0.23%	647	0.02%	15,991	0.48%
1989	31,020	0.96%	24,004	0.75%	801	0.02%	9,540	0.30%	310	0.01%	15,575	0.48%
1988	17,163	0.56%	33,709	1.10%	279	0.01%	9,988	0.33%	812	0.03%	24,812	0.81%
1987	37,544	1.26%	6,579	0.22%	1,427	0.05%	5,404	0.18%	201	0.01%	2,803	0.09%
1986	22,106	0.78%	18,456	0.65%	3,951	0.14%	5,266	0.19%	276	0.01%	17,418	0.61%
1985	17,774	0.68%	21,813	0.83%	1,565	0.06%	5,629	0.21%	228	0.01%	17,977	0.69%
1984	13,816	0.57%	20,146	0.83%	(140)	-0.01%	4,721	0.19%	218	0.01%	15,502	0.64%
1983	10,802	0.48%	18,896	0.83%	(21)	-0.00%	4,017	0.18%	73	0.00%	14,931	0.66%
1982	8,342	0.40%	19,245	0.91%	(1,280)	-0.06%	3,037	0.14%	68	0.00%	14,996	0.71%
1981	5,066	0.26%	20,234	1.04%	(1,583)	-0.08%	3,904	0.20%	56	0.00%	14,803	0.76%
1980	4,478	0.25%	19,505	1.10%	(854)	-0.05%	4,658	0.26%	17	0.00%	14,010	0.79%
1979	3,785	0.24%	17,891	1.12%	(650)	-0.04%	4,442	0.28%	39	0.00%	12,838	0.80%
1978	3,526	0.25%	15,101	1.06%	(447)	-0.03%	3,940	0.28%	45	0.00%	10,759	0.76%
1977	3,303	0.26%	11,565	0.92%	142	0.01%	2,875	0.23%	47	0.00%	8,879	0.70%
1976	3,691	0.33%	9,914	0.87%	312	0.03%	2,409	0.21%	26	0.00%	7,843	0.69%
1975	3,612	0.34%	8,977	0.85%	37	0.00%	1,793	0.17%	34	0.00%	7,255	0.68%
1974	2,290	0.25%	9,238	0.99%	(87)	-0.01%	2,084	0.22%	12	0.00%	7,079	0.76%
1973	1,264	0.16%	8,709	1.12%	(27)	-0.00%	2,122	0.27%	22	0.00%	6,582	0.85%
1972	972	0.14%	7,252	1.06%	92	0.01%	1,708	0.25%	20	0.00%	5,656	0.83%
1971	868	0.14%	6,713	1.12%	213	0.04%	1,689	0.28%	(1)	-0.00%	5,236	0.87%
1970	703	0.13%	7,127	1.30%	(104)	-0.02%	2,173	0.40%	(13)	-0.00%	4,837	0.88%
1969	521	0.10%	6,728	1.31%	(237)	-0.05%	2,164	0.42%	7	0.00%	4,334	0.85%
1968	512	0.11%	5,509	1.16%	(457)	-0.10%	1,266	0.27%	NA	0.00%	3,786	0.80%
1967	434	0.10%	4,707	1.10%	(21)	-0.00%	1,177	0.28%	NA	0.00%	3,509	0.82%
1966	417	0.11%	4,462	1.15%	(392)	-0.10%	1,030	0.26%	NA	0.00%	3,040	0.78%
1965	324	0.09%	3,891	1.08%	(0)	-0.00%	1,029	0.29%	NA	0.00%	2,861	0.79%
1964	251	0.08%	3,764	1.15%	(14)	-0.00%	1,148	0.35%	NA	0.00%	2,602	0.79%
1963	238	0.08%	3,502	1.15%	118	0.04%	1,227	0.40%	NA	0.00%	2,393	0.79%
1962	167	0.06%	3,406	1.19%	198	0.07%	1,256	0.44%	NA	0.00%	2,348	0.82%
1961	190	0.07%	3,371	1.26%	409	0.15%	1,406	0.53%	NA	0.00%	2,374	0.89%
1960	206	0.08%	3,532	1.41%	110	0.04%	1,384	0.55%	NA	0.00%	2,257	0.90%
1959	53	0.02%	3,135	1.30%	(698)	-0.29%	884	0.37%	NA	0.00%	1,553	0.65%
1958	61	0.03%	2,766	1.21%	588	0.26%	1,271	0.55%	NA	0.00%	2,082	0.91%
1957	72	0.03%	2,750	1.26%	(173)	-0.08%	998	0.46%	NA	0.00%	1,578	0.72%
1956	92	0.04%	2,577	1.21%	(286)	-0.13%	815	0.38%	NA	0.00%	1,476	0.69%
1955	49	0.02%	2,278	1.11%	(164)	-0.08%	794	0.39%	NA	0.00%	1,320	0.64%
1954	44	0.02%	2,031	1.04%	350	0.18%	908	0.46%	NA	0.00%	1,473	0.75%
1953	59	0.03%	1,974	1.05%	(117)	-0.06%	786	0.42%	NA	0.00%	1,070	0.57%
1952	35	0.02%	1,826	1.00%	(64)	-0.03%	695	0.38%	NA	0.00%	1,067	0.59%
1951	35	0.02%	1,634	0.95%	(27)	-0.02%	559	0.33%	NA	0.00%	1,047	0.61%
1950	29	0.02%	1,448	0.90%	52	0.03%	428	0.27%	NA	0.00%	1,072	0.67%
1949	59	0.04%	1,259	0.82%	35	0.02%	325	0.21%	NA	0.00%	968	0.63%
1948	28	0.02%	1,235	0.81%	(19)	-0.01%	275	0.18%	NA	0.00%	941	0.62%
1947	53	0.04%	1,096	0.73%	(18)	-0.01%	302	0.20%	NA	0.00%	775	0.52%
1946	(3)	-0.00%	1,141	0.75%	76	0.05%	323	0.21%	NA	0.00%	894	0.59%
1945	(11)	-0.01%	1,059	0.72%	134	0.09%	299	0.20%	NA	0.00%	894	0.61%
1944	(14)	-0.01%	920	0.75%	19	0.02%	203	0.16%	NA	0.00%	736	0.60%
1943	(10)	-0.01%	764	0.74%	(13)	-0.01%	128	0.12%	NA	0.00%	623	0.60%
1942	12	0.01%	560	0.65%	(54)	-0.06%	80	0.09%	NA	0.00%	426	0.49%
1941	33	0.04%	460	0.62%	(16)	-0.02%	8	0.01%	NA	0.00%	436	0.59%
1940	48	0.07%	404	0.60%	(15)	-0.02%	6	0.01%	NA	0.00%	383	0.57%
1939	71	0.12%	375	0.63%	(0)	-0.00%	5	0.01%	NA	0.00%	370	0.62%
1938	94	0.17%	334	0.60%	(49)	-0.09%	4	0.01%	NA	0.00%	281	0.51%
1937	52	0.09%	421	0.76%	(59)	-0.11%	5	0.01%	NA	0.00%	357	0.65%
1936	140	0.26%	379	0.71%	113	0.21%	2	0.00%	NA	0.00%	490	0.91%
1935	237	0.49%	385	0.79%	(211)	-0.43%	NA	0.00%	NA	0.00%	174	0.36%
1934	500	--	20	--	(377)	--	NA	--	NA	--	(357)	--

Note: All percentages for 9/94 have been annualized (x1.33), dollar amounts have not been annualized

Source: Statistics on Banking, 1934-1993

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TABLE IV

Selected Condition and Performance Ratios for Insured Commercial Banks 1934-1994

(Percentages)

Year	Troubled Assets/ Total Assets	Allow for Ln & Lse Losses /Noncurrent Loans	Net C/O to Average Total Loans	Allow for Ln & Lse Losses /Loans	Net C/O to Provision for Ln & Lse Losses	Tot Eq Cap + Reserves – Noncurr Lns/ Assets	Total Eq Cap/ Assets	Return on Assets *	Return on Equity *
09/94	1.17%	157.04%	0.37%	2.30%	100.87%	8.43%	7.95%	1.19%	14.89%
1993	1.61%	123.14%	0.84%	2.45%	105.27%	8.28%	8.01%	1.20%	15.50%
1992	2.53%	87.57%	1.26%	2.68%	98.46%	7.29%	7.51%	0.92%	12.93%
1991	3.02%	72.55%	1.58%	2.69%	95.79%	6.15%	6.75%	0.53%	7.97%
1990	2.94%	71.07%	1.43%	2.63%	92.57%	5.78%	6.45%	0.48%	7.55%
1989	2.30%	86.50%	1.15%	2.61%	73.81%	5.95%	6.21%	0.48%	7.76%
1988	2.16%	82.74%	0.99%	2.41%	108.47%	5.97%	6.28%	0.81%	13.16%
1987	2.48%	78.74%	0.92%	2.73%	43.76%	5.57%	6.02%	0.09%	1.55%
1986	1.96%	59.61%	0.98%	1.65%	74.99%	5.53%	6.19%	0.61%	9.92%
1985	1.87%	53.00%	0.84%	1.43%	74.54%	5.44%	6.19%	0.69%	11.12%
1984	1.97%	42.90%	0.77%	1.24%	78.45%	5.15%	6.14%	0.64%	10.52%
1983	NA	NA	0.67%	1.17%	78.78%	NA	6.00%	0.66%	11.11%
1982	NA	NA	0.56%	1.08%	78.63%	NA	5.84%	0.71%	12.18%
1981	NA	NA	0.35%	1.01%	74.04%	NA	5.82%	0.76%	13.18%
1980	NA	NA	0.37%	0.99%	80.28%	NA	5.75%	0.79%	13.77%
1979	NA	NA	0.29%	0.97%	67.74%	NA	5.73%	0.80%	13.96%
1978	NA	NA	0.32%	0.95%	70.82%	NA	5.77%	0.76%	12.94%
1977	NA	NA	0.41%	0.94%	84.68%	NA	5.92%	0.70%	11.72%
1976	NA	NA	0.57%	1.00%	94.93%	NA	6.11%	0.69%	11.50%
1975	NA	NA	0.55%	1.53%	89.78%	NA	5.90%	0.68%	11.78%
1974	NA	NA	0.38%	1.47%	85.46%	NA	5.70%	0.76%	12.43%
1973	NA	NA	0.27%	1.65%	91.32%	NA	6.68%	0.85%	12.75%
1972	NA	NA	0.25%	1.70%	91.27%	NA	6.62%	0.83%	12.24%
1971	NA	NA	0.35%	1.87%	125.25%	NA	6.95%	0.87%	12.37%
1970	NA	NA	0.34%	2.01%	139.61%	NA	7.12%	0.88%	12.36%
1969	NA	NA	0.18%	2.05%	93.80%	NA	7.18%	0.85%	12.02%
1968	NA	NA	0.16%	1.97%	80.27%	NA	6.89%	0.80%	11.40%
1967	NA	NA	0.19%	1.99%	99.54%	NA	7.09%	0.82%	11.34%
1966	NA	NA	0.19%	1.97%	96.40%	NA	7.42%	0.78%	10.45%
1965	NA	NA	0.17%	1.98%	99.89%	NA	7.53%	0.79%	10.43%
1964	NA	NA	0.15%	1.99%	100.16%	NA	7.72%	0.79%	10.04%
1963	NA	NA	0.16%	1.88%	100.11%	NA	8.08%	0.79%	9.78%
1962	NA	NA	0.12%	1.89%	100.10%	NA	8.02%	0.82%	10.24%
1961	NA	NA	0.15%	2.05%	100.01%	NA	7.97%	0.89%	11.11%
1960	NA	NA	0.18%	1.97%	100.12%	NA	8.05%	0.90%	11.33%
1959	NA	NA	0.05%	1.92%	100.82%	NA	7.89%	0.65%	8.31%
1958	NA	NA	0.06%	1.95%	100.09%	NA	7.65%	0.91%	11.82%
1957	NA	NA	0.08%	1.86%	99.40%	NA	7.70%	0.72%	9.55%
1956	NA	NA	0.11%	1.70%	100.07%	NA	7.40%	0.69%	9.53%
1955	NA	NA	0.06%	1.52%	100.82%	NA	7.16%	0.64%	9.03%
1954	NA	NA	0.06%	1.50%	100.83%	NA	7.11%	0.75%	10.72%
1953	NA	NA	0.09%	1.41%	99.87%	NA	6.93%	0.57%	8.30%
1952	NA	NA	0.06%	1.40%	99.23%	NA	6.73%	0.59%	8.73%
1951	NA	NA	0.06%	1.40%	99.65%	NA	6.71%	0.61%	9.04%
1950	NA	NA	0.06%	1.28%	99.14%	NA	6.75%	0.67%	9.80%
1949	NA	NA	0.14%	1.27%	100.43%	NA	6.84%	0.63%	9.33%
1948	NA	NA	0.07%	0.97%	101.03%	NA	6.66%	0.62%	9.48%
1947	NA	NA	0.15%	NA	99.40%	NA	6.35%	0.52%	8.18%
1946	NA	NA	−0.01%	NA	108.20%	NA	6.28%	0.59%	10.00%
1945	NA	NA	−0.05%	NA	101.03%	NA	5.48%	0.61%	10.79%
1944	NA	NA	−0.07%	NA	100.96%	NA	5.90%	0.60%	9.56%
1943	NA	NA	−0.06%	NA	104.41%	NA	6.64%	0.60%	8.59%
1942	NA	NA	0.06%	NA	100.84%	NA	7.39%	0.49%	6.13%
1941	NA	NA	0.17%	NA	99.76%	NA	8.91%	0.59%	6.46%
1940	NA	NA	0.27%	NA	99.61%	NA	9.44%	0.57%	5.80%
1939	NA	NA	0.43%	NA	99.37%	NA	10.33%	0.62%	5.71%
1938	NA	NA	0.57%	NA	99.68%	NA	11.33%	0.51%	4.37%
1937	NA	NA	0.32%	NA	99.38%	NA	11.81%	0.65%	5.61%
1936	NA	NA	0.91%	NA	99.76%	NA	11.26%	0.91%	7.81%
1935	NA	NA	1.62%	NA	99.97%	NA	12.19%	0.36%	2.82%
1934	NA	NA	--	NA	100.00%	NA	13.24%	--	--

* 9/94 percentage is annualized

Data are for all insured commercial banks

Source: Historical Statistics on Banking, 1934–1993

NOTES TO TABLES I-IV

*Data are for all insured commercial banks

[1]Credit risk diversified – Lending relatively small amounts of credit to a large number of borrowers. The degree of credit risk varies from geographic location to location and from institution to institution.

[2]Credit risk concentrated – Lending relatively large amounts of credit to a relatively small number of borrowers. Repayment failure could impair the income or capital position of individual institutions.

[3]Beginning in 1976, banks were required to allocate their IRS Reserve for Bad Debt Losses on Loans into its three components: the valuation portion, to be reflected as a deduction from loans, the deferred tax portion, to be shown as an other liability, and the contingency portion, to be reflected in the equity capital secion as undivided profits or as reserves for contingencies and other capital reserves. Hence, the nearly 30% drop in the dollar amount of the reserve between 1975 and 1976.

Source: Historical Statistics on Banking 1934–1993

ATTACHMENT C

HISTORICAL BACKGROUND

Information concerning the principal abuses that arose during the 1920s and early 1930s in connection with the investment banking activities of commercial bank affiliates is largely limited to the extensive Senate investigation into stock exchange practices, which included the highly publicized Pecora hearings. A substantial portion of these hearings, which were held in 1933 and 1934, dealt with the activities of the securities affiliates of the country's two largest commercial banks, National City Bank and Chase National Bank.

The Glass-Steagall Act, which to a certain extent was the result of these hearings, was enacted primarily for three reasons. First, Congress believed the Act would help to protect and maintain the financial stability of the commercial banking system, and would strengthen public confidence in commercial banks. Second, Congress wanted to eliminate the potential for conflicts of interest that could result from the performance of both commercial and investment banking operations. The final Congressional concern was a belief that the securities operations of banks tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities activities.

The actual and potential abuses that were revealed during the Senate investigation can be categorized as follows: first, abuses that were common to the entire investment banking industry; second, abuses that may be attributed to the use of affiliates for the personal profit of bank officers and directors; and third, abuses related to conflicts of interest that resulted from the mixing of commercial and investment banking functions. The primary types of abuses relevant to each of these categories are discussed below. Analyses of the appropriate remedies for these abuses are presented, together with comments directed toward examining the degree to which the Glass-Steagall Act was an effective or desirable solution.

Abuses Common to the Investment Banking Business

The principal types of abuses common to the investment banking business during the 1920s and early 1930s included:

- underwriting and distributing unsound and speculative securities

- conveying untruthful or misleading information in the prospectuses accompanying new issues

- manipulating the market for certain stocks and bonds while they were being issued.

Examples of the first two types of abuses can be found by examining National City Company's involvement in the financial operations of the Republic of Peru. Throughout the 1920s National City Company received reports that Peru was politically unstable, had a bad debt record, suffered from a depleted Treasury and was, in short, an extremely poor credit risk. In 1927 and 1928, National City Company participated, nevertheless, in the underwriting of bond issues by the government of Peru. The prospectuses that were distributed made no mention of Peru's political and economic difficulties. As a result, the public purchased $90 million of the bonds, which went into default in 1931 and sold for less than five percent of their face value in 1933.

While the National City case may be one of the more flagrant examples of these types of abuses, it was generally acknowledged that the extremely competitive banking environment of the 1920s led bankers to encourage overborrowing, particularly by governments and political subdivisions in Europe and South America. Questionable practices were employed to induce the public to purchase the security issues that resulted from the promotional efforts of bank affiliates. In addition to falsifying or withholding pertinent information, National City Company and Chase Securities Corporation attempted, on occasion, to prop up the price of securities while the securities were being sold.

A large portion of the abuses uncovered during the Pecora hearings were common to the entire investment banking industry. Because these problems were not directly related to the relationship between banks and their affiliates, the Glass-Steagall Act was not the proper remedy for these kinds of abuses. There are several reasons why the problems just described are of less concern today. First, the Securities Act of 1933 and the Securities Exchange Act of 1934 hold individuals involved in the issuance of securities responsible for any misstatement of facts or failure to reveal pertinent information concerning the financial condition of governments and corporations issuing securities. Second, it is now the duty of the SEC to prevent any manipulation of the market while a security is being issued. Additionally, these safeguards may help deter banks from underwriting unsound and speculative securities.

Self-Dealing by Bank Officers and Directors

Bank affiliates not only attempted to manipulate the stock and bond prices of other business and governmental entities, they also attempted to manipulate the stock prices of their parent banks. The procedure generally employed was for the affiliate to organize investment pools that traded in the stock of the parent bank. While the pools were financed primarily by the affiliates, they were generally open to selected individuals, including bank

officers and directors. Bank officials claimed that the purposes of such trading accounts were to steady the market in order to maintain public confidence in the bank and to encourage increased distribution of the bank's stock. However, there were other motivations for such activity.

First, it is likely that many of the participants expected to benefit from their inside information and gain large profits from their trading activity. In practice, however, these expectations were not always realized. Chase's affiliates earned only $159,000 in profit on trades in Chase National Bank stock totaling $900 million. National City Company sustained $10 million in losses from dealing in the stock of its parent bank.

A second reason may have been that by advancing the stock's price it became more attractive to the stockholders of other banks that were acquired on an exchange-of-stock basis. Chase National and National City Bank each acquired several other banks during the period when their affiliates were trading in their stock.

In addition to the profits obtained by trading in their own bank's stock, bank officers and directors often received compensation from affiliates far in excess of that paid to them by their banks. For example, instead of permitting the stock of affiliates to be owned by bank stockholders, the stock was often wholly owned by officers and directors of the bank. This "ownership" may have been illegal and was clearly improper. Because the profit opportunities of the affiliates were a direct result of their association with their parent banks, any profits they derived rightfully belonged to the bank's stockholders.

The types of abuses just described sparked public outrage against commercial banks and their investment banking affiliates. However, the Glass-Steagall Act was not the proper remedy for such self-dealing and insider abuse. Trading accounts in the stock of parent banks by affiliates and the participation in such trading by bank officials could have been prevented by making it illegal for affiliates to deal in or own the stock of parent banks. The establishment of management funds is a problem mainly of concern to stockholders. With adequate disclosure of the salaries and bonuses distributed through such funds, stockholders can determine whether they are excessive. Affiliates owned entirely by bank officers and directors instead of by bank stockholders also could have been prohibited.

<u>Abuses Arising From the Mixture of Commercial and Investment Banking</u>

There were a number of abuses that occurred from the mixing of commercial and investment banking functions. Most of these relate to conflict-of-interest concerns, and while they have

implications for bank safety and soundness, there is no evidence that a large number of bank failures were due to interactions between banks and their affiliates. The types of abuses revealed during Senate testimony in 1933-34 included:

- Using the affiliate as a dumping ground for bad bank loans. In an example highlighted during the Pecora hearings, National City Bank transferred to National City Company $25 million worth of loans to Cuban sugar producers after the price of sugar collapsed and the borrowers were unable to repay the loans.

- Using the bank or its trust department as a receptacle for securities the affiliate could not sell. While examples where Chase National Bank bailed out its affiliates were revealed during the Senate investigation, it appears that trust departments generally were not used for such a purpose.

- Lending to finance the purchase of securities underwritten by the affiliate. This could have been another means whereby the affiliate's problems were transferred to the bank. That is, if the affiliate found it difficult to sell a particular issue, the bank may have chosen to offer loans to prospective purchasers under conditions disadvantageous to bank stockholders.

- Excessive lending to affiliates to finance underwritings. This practice may have led to an inadequate level of bank asset diversification, the significance of which would have depended upon the quality of the underwritings.

- There was a tendency for banks to invest too much in long-term securities. This practice caused liquidity problems that contributed to a number of bank failures during the late 1920s.

- Lowering the quality of bank assets by purchasing part of a poorly performing security after it had been issued. The reason for such action would have been that the bank was concerned with its image if a security its affiliate had underwritten or distributed began to lose value.

- Lending to a corporation that would otherwise have defaulted on an issue underwritten by the bank's securities affiliate. Again, this would have occurred if a bank was concerned that its image would be severely tarnished in the event a corporation defaulted on an issue the bank's affiliate had underwritten or distributed.

The first five problems outlined above could have been controlled with fairly simple legislative remedies. For example, to prevent the use of a bank or its affiliate as the dumping ground for the other's bad assets, federal authorities could have been given, and now have, authority to conduct simultaneous examinations on a periodic basis. Lending to finance the

purchase of securities underwritten by a bank's affiliate could have been prohibited. The concern that banks may lend excessive amounts to their affiliates could be handled by prohibiting such lending, by requiring that it be collateralized, or by simply placing a limit, perhaps as a percentage of bank capital, on the amount a bank may invest in any one and in all of its affiliates. However, the underlying concern in this case is that banks, by investing heavily in their affiliates, would not have a sufficiently diversified asset base. This concern can also be directly addressed by limiting overall investments in related markets or product lines. Similarly, the tendency for banks to invest too much in long-term securities could be controlled by prohibiting or limiting the number or amount of securities a bank could purchase from operating securities affiliates.

The potential for "tie-ins" also should be of concern. While it appears that investment banks can, and on occasion do, threaten to withhold certain services unless an entire "package" is purchased, the power of such a threat takes on a somewhat greater significance when it is a line of credit that might be withdrawn if an issuer does not choose a particular bank or bank affiliate as its underwriter. As with the previous two concerns it does not appear that examples of abuse were uncovered during the Pecora hearings.

The types of potential tie-ins that should be of concern to public policymakers are due either to self-dealing or to inadequate levels of competition. In neither case is a continued separation of commercial and investment banking an appropriate way to address effectively the problem. An example of the former is if a bank official tried to induce potential customers into purchasing a service (presumably, but not necessarily, at a relatively high price), in which the official had a personal interest, by tying-in and underpricing at the expense of the bank's or its affiliate's stockholders a second service in which the official's personal stake was less direct. Self-dealing of this kind can largely be prevented by other means.

In the absence of self-dealing at the expense of the benefactors of the proceeds of one of the tied-in services, the only way the tie-in threat can be effective is if the customer has no viable alternative. In competitive markets, customers would simply purchase the services elsewhere at more reasonable rates. This type of tie-in, to the extent it can occur, represents only one facet of a broader antitrust concern which is most appropriately dealt with through policies designed to foster greater competition. Since most banking markets are reasonably competitive, it is highly unlikely that investment bankers, as a group, will be at an unfair competitive advantage due to such tie-ins. Moreover, since nondepository institutions are becoming more involved in the extension of credit, it is difficult to argue that commercial banks should not be permitted to underwrite

corporate securities on the grounds that such tie-ins are possible.

Conclusion

By the 1930s, the general view in Congress was that the mixing of commercial and investment banking posed a threat to the safety and soundness of the banking system, created numerous conflict-of-interest situations and led to economic instability due to the channeling of bank deposits into "speculative" securities activities. To alleviate those concerns, the Glass-Steagall Act was enacted.

From the evidence gathered during the Senate investigation into stock exchange practices it appears that, to the extent the concerns of Congress were valid, they could have been handled through less disruptive legislative means. There is little evidence that the investment banking activities of commercial bank affiliates were a major factor in causing bank failures. Where investments in securities underwritten by affiliates contributed to an institution's failure, it was generally because the bank was illiquid due to an overinvestment in long-term assets. Affiliate losses were generally due to speculative activities unrelated to investment banking.

Most of the abuses that arose during the 1920s in connection with the operation of security affiliates by commercial banks appear to have been conflict of interest concerns rather than factors threatening the safety and soundness of commercial banks. However, it appears that most of these problems could have been remedied without having to resort to a forced separation of commercial and investment banking. Certain abuses which arise from mixing commercial and investment banking cannot entirely be controlled; but, they do not appear to have been so significant as to have warranted legislation separating commercial and investment banking. Finally, the provision of the 1934 Securities Exchange Act that authorized the Federal Reserve Board to regulate the extension of credit for the purchase of securities effectively achieved the third objective of the Glass-Steagall Act, which was to control the speculative uses of bank assets in the securities markets.

In conclusion, bank affiliates were not regulated, examined, or in any way restricted in the activities they could participate in until the 1930s. As a result, abuses occurred. A certain degree of supervision and regulation and some restrictions on bank affiliate powers would have gone a long way towards eliminating the types of abuses that occurred during this period.

ATTACHMENT D

CURRENT SAFEGUARDS

Section 23A of the Federal Reserve Act restricts transactions between member banks and their affiliates, and the Federal Deposit Insurance Act extends the coverage of 23A to nonmember insured banks. Section 23A attempts to prevent the misuse of insured institutions by placing quantitative limitations on "covered transactions" between a bank and its affiliate, establishing collateral requirements for certain transactions, requiring that all transactions be on terms and conditions that are consistent with safe and sound banking, and prohibiting a bank from purchasing low-quality assets of an affiliate. "Covered transactions" include loans to an affiliate, purchases of securities issued by an affiliate, acceptance of securities issued by an affiliate as collateral, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Section 23B of the Federal Reserve Act places additional limitations on federally insured banks and their affiliates, by providing that a bank may engage in certain transactions with its affiliates only on an "arm's length" basis. In addition to the "covered transactions" of Section 23A, Section 23B applies to the sale of securities or other assets to an affiliate, to service contracts between the bank and its affiliate, and to transactions with a third party where the affiliate has a financial interest in the third party.

The Federal Reserve Board has established prudential limitations on the activities of the "Section 20 companies" of bank holding companies (BHCs) that underwrite and deal in debt and equity securities to a limited extent. Among other things, in determining capital compliance, BHCs must deduct from consolidated primary capital any investment in an underwriting subsidiary, or any extension of credit that does not meet certain collateral requirements. BHCs and their subsidiaries are prohibited from: entering into any financial arrangement that might be viewed as enhancing the marketability of a bank-ineligible security issued by the underwriting subsidiary; extending credit to a customer to purchase a bank-ineligible security issued by the securities affiliate during or shortly after the underwriting period; or purchasing ineligible securities from a securities affiliate during or shortly after the underwriting period. Officer, director or employee interlocks between a BHC's underwriting subsidiary and any bank or thrift subsidiary are prohibited. An underwriting subsidiary must provide adequate disclosures that its products are not federally insured. There are limitations on the ability of affiliated banks or thrifts to provide investment advice regarding the purchase of securities underwritten or dealt in by the securities affiliate. Bank or thrift subsidiaries are prohibited from extending credit to a securities affiliate except

in certain limited instances, or from purchasing or selling certain financial assets to or from a securities affiliate.

On December 28, 1984, the FDIC implemented its regulation on securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies (12 CFR § 337.4). At that time, the FDIC determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities if authorized under state law. At the same time, the FDIC found that some risk may be associated with those activities. In order to address that risk, the FDIC regulation (1) defines bona fide subsidiary, (2) requires notice of intent to acquire or establish a securities subsidiary, (3) limits the permissible securities activities of insured nonmember bank subsidiaries, and (4) places certain other restrictions on loans, extensions of credit and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities.

In our regulation, the term "bona fide" subsidiary means a subsidiary of an insured nonmember bank that at a minimum: (1) is adequately capitalized, (2) is physically separate and distinct in its operations from the operations of the bank, (3) maintains separate accounting and other corporate records, (4) observes separate corporate formalities such as separate board of directors meetings, (5) maintains separate employees who are compensated by the subsidiary, (6) shares no common officers with the bank, (7) a majority of the board of directors is composed of persons who are neither directors nor officers of the bank, and (8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

This definition is imposed to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. Also, the separation safeguards the soundness of the parent bank.

The regulation provides that the insured nonmember bank must give the FDIC written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummating the acquisition or commencement of the operation of the subsidiary. These notices serve as a supervisory mechanism to apprise the FDIC of which insured nonmember banks are conducting securities activities through

their subsidiaries that pose potential risks to which the bank otherwise would not be exposed.

Activities of the subsidiary are limited in that it may not engage in the underwriting of securities that would otherwise be prohibited to the bank itself under the Glass-Steagall Act unless the subsidiary meets the bona fide definition and the activities are limited to underwriting of investment quality securities.

A subsidiary may engage in underwriting other than that listed above if it meets the definition of bona fide and the following conditions are met:

(a) The subsidiary is a member in good standing of the National Association of Securities Dealers (NASD);

(b) The subsidiary has been in continuous operation for a five-year period preceding the notice to the FDIC;

(c) No director, officer, general partner, employee or 10 percent shareholder has been convicted within five years of any felony or misdemeanor in connection with the purchase or sale of any security;

(d) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders is subject to any state or federal administrative order or court order, judgment or decree arising out of the conduct of the securities business;

(e) None of the subsidiary's directors, officers, general partners, employees or 10 percent shareholders are subject to an order entered within five years issued by the Securities and Exchange Commission pursuant to certain provisions of the Securities Exchange Act of 1934 or the Investment Advisors Act of 1940; and

(f) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

A bona fide subsidiary must be adequately capitalized, and therefore, they must meet the capital standards of the NASD and SEC. As a protection to the insurance fund, a bank's investment in these subsidiaries engaged in securities activities that would be prohibited to the bank under the Glass-Steagall Act is not counted toward the bank's capital, that is, the investment in the subsidiary is deducted before compliance with capital requirements is measured.

An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acts as an investment advisor to any investment company may not engage in any of the following transactions:

(1) Purchase in its discretion as fiduciary any security currently distributed, underwritten or issued by the subsidiary unless the purchase is authorized by a trust instrument or is permissible under applicable law;

(2) Transact business through the trust department with the securities firm unless the transactions are at least comparable to transactions with an unaffiliated company;

(3) Extend credit or make any loan directly or indirectly to any company whose obligations are underwritten or distributed by the securities firm unless the securities are of investment quality;

(4) Extend credit or make any loan directly or indirectly to any investment company whose shares are underwritten or distributed by the securities company;

(5) Extend credit or make any loan where the purpose of the loan is to acquire securities underwritten or distributed by the securities company;

(6) Make any loans or extensions of credit to a subsidiary or affiliate of the bank that distributes or underwrites securities or advises an investment company in excess of the limits and restrictions set by section 23A of the Federal Reserve Act;

(7) Make any loan or extension of credit to any investment company for which the securities company acts as an investment advisor in excess of the limits and restrictions set by section 23A of the Federal Reserve Act; and,

(8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with the banks securities company to underwrite or distribute the company's securities or condition a loan to a person on the requirement that the person purchase any security underwritten or distributed by the bank's securities company.

An insured nonmember bank is prohibited by regulation from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the

operation of the bank; (2) the bank and the affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors or officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities of the affiliate on the premises of the bank that involve customer contact; and (5) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank. The FDIC has chosen not to require notices relative to affiliates because we would normally find out about the affiliation in a deposit insurance application or a change of bank control notice.

The FDIC has created an atmosphere in which bank affiliation with entities engaged in securities activities is very controlled. Although we have examination authority over bank subsidiaries and under Section 10(b) of the Federal Deposit Insurance Act we have the authority to conduct examinations of affiliates to determine the effect of that relationship on the insured institution, we have in practice allowed these entities to be functionally regulated, that is FDIC examination of the insured bank and SEC and NASD oversight of the securities subsidiary or affiliate.

The FDIC feels that its established separations for banks and securities firms has created an environment in which the FDIC's responsibility to protect the insurance fund has been met without creating duplicative regulation for the securities firms. However, our experience indicates that these separations may not be perfect. Insider maneuvering may be able to evade the intent of the firewalls, securities firms affiliated with nonbank bank holding companies may fall outside the regulatory coverage of Part 337.4, and if systemic problems were to develop in the securities industry, the difficulties may overwhelm the protection in place.

Therefore, the FDIC believes that functional regulation should not be designed in a fashion that would preclude the FDIC from examining securities subsidiaries and affiliates for matters which are unsafe and unsound. This would include reviewing insider involvement in the securities firms, monitoring financial transactions between the insured institution and the securities firm, reviewing securities firms records to assure that the restrictions contained in Part 337.4 are being adhered to, and regularly reviewing financial statements of the securities firms.

The FDIC is also maintaining an open dialogue with the NASD and the SEC concerning matters of mutual interest. To that end,

we have entered into an agreement in principle with the NASD concerning examination of securities companies affiliated with insured institutions and have begun a dialogue with the SEC concerning the exchange of information which may be pertinent to the mission of the FDIC.

The number of banks which have subsidiaries engaged in activities that could not be conducted in the bank itself is very small. The activities these subsidiaries are engaged in are underwriting of debt and equity securities and distribution and management of mutual funds. We have received notices from 444 banks that have subsidiaries which are engaged in activities that do not require the subsidiary to meet the definition of bona fide such as investment advisory activities, sale of securities and management of the bank's securities portfolio.

Since implementation of the FDIC's regulation, the relationships between banks and securities firms have not been a matter of supervisory concern. We believe in great part that this can be attributed to the protections we have in place. However, we are aware that in a time of financial turmoil that these protections may not be adequate and a program of direct examination may be necessary to protect the insurance fund and continuation of our examination authority in that area is important.

ATTACHMENT E

PROHIBITIONS AND RESTRICTIONS ON SECURITIES ACTIVITIES IMPOSED BY SECTION 20 OF THE GLASS-STEAGALL ACT AND BY THE BANK HOLDING COMPANY ACT

Section 20 of the Glass-Steagall Act ("Section 20") (12 U.S.C. §377) prohibits banks that are members of the Federal Reserve System ("member banks") from affiliating with organizations that are "engaged principally" in underwriting, distributing or selling securities. Section 20 states, in relevant part, that: "no member bank shall be affiliated in any manner . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale . . . of stocks, bonds, debentures, notes, or other securities . . . ." 12 U.S.C. §377. The statute defines an "affiliate" to include any corporation, business trust, association or other similar organization --

> (1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the number of shares voted for the election of directors, trustees, or other persons exercising similar functions . . .
>
> (2) Of which control is held, directly or indirectly, through stock ownership . . . by the shareholders of the member bank who own or control either a majority of the shares of such bank or more than 50 percent of the number of shares voted for the election of directors of such bank . . .
>
> (3) Of which a majority of directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
>
> (4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more that 50 percent of the number of shares voted for the election of directors of a member bank . . . . 12 U.S.C. §221a.

In contrast to Section 16 of the Glass-Steagall Act, which imposes an absolute ban on bank securities underwriting activities, Section 20 prohibits affiliations between banks and entities that are "engaged principally" in securities underwriting activities. Therefore, affiliations are permitted

as long as the nonbank institution is not engaged "principally" in the securities activities restricted by Section 20. Section 20 itself, however, does not define the term "principally engaged." The legislative history of Section 20 also fails to define or explain the precise meaning of the term.[1] To date, the United States Supreme Court has not ruled on the question and very few lower federal courts have addressed it.[2] Thus, the meaning of the term "engaged principally" is not firmly resolved. Based on court decisions on other related provisions of the Glass-Steagall Act, and absent further clarification by the United States Supreme Court, the term "engaged principally" is not confined to the majority of a firm's business. Instead, any bank affiliate engaged in securities underwriting as a "substantial activity" would be in violation of Section 20.[3] A determination of what level of activity is "substantial," however, is still required.

The Federal Reserve has approved numerous applications allowing so-called "Section 20 subsidiaries" to underwrite and deal in securities (that are not exempt from the Glass-Steagall restrictions (i.e.,"ineligible securities")) on the grounds that the subsidiaries are not "engaged principally" in such activities, and thus their affiliation with member banks is not proscribed by Section 20.[4] In a precedential order issued in 1987 ("1987 Order") the Board of Governors of the Federal Reserve System imposed a "five-to-ten-percent" standard to differentiate permissible from impermissible levels of securities underwriting activities. The Board explained its rationale, in part, as follows:

> [T]he Board believes it is bound by the statutory language of section 20 [of the Glass-Steagall Act] to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the application, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The

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[1] See Banking Law, Vol. 5, § 96.02[3] (Matthew Bender, 1994).

[2] In Board of Governors v. Agnew, 329 U.S. 441 (1947), the United States Supreme court defined the term "primarily" to mean "substantial." This was in the context of section 32 of the Glass-Steagall Act, however, and not Section 20. (Section 32 restricts officer, director and employee overlap between member banks and entities "primarily engaged" in securities underwriting.)

[3] Cf. Board of Governors v. Agnew, supra

[4] The Federal Reserve has approved the establishment of over thirty "Section 20 subsidiaries." 59 Fed. Reg. 35,517 (1994).

Board reaffirms its conclusion . . . that Congress intended that the 'engaged principally' standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks . . . .

With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between five to ten percent of its total gross revenues . . . . " Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp., 73 Fed. Res. Bull. 473, 475 (1987).[5]

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[5] The Federal Reserve Board's standard was sustained by the Second Circuit Court of Appeals in Sec. Ind. Ass'n v. Board of Governors, 839 F.2d 47, 68 (2d Cir. 1988), cert. denied, 486 U.S. 1059 (1988).

In July 1994, the Federal Reserve requested comments on proposed alternatives to the current "gross revenue" and "indexed gross revenue" tests. 59 Fed Reg. 35,516 (1994).

With specified exceptions, the Bank Holding Company Act[6] ("BHC Act) prohibits a Bank Holding Company ("BHC") from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank (12 U.S.C. §1843(a)). Under Section 4(c)(8) of the BHC Act (Id. at 1843(c)(8)) that prohibition does not apply to a BHC's acquisition of "shares of any company the activities of which the [Federal Reserve] Board . . . has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto . . . ."[7] In the 1987 Order the Federal Reserve concluded that underwriting and dealing in "ineligible securities" is "closely related" and a "proper incident" to banking under the BHC Act.[8]

Specifically, the Board of Governors stated that "underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in [the 1987] Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services . . . [T]he proposed activities are natural extensions

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[6] The BHC Act requires approval by the Federal Reserve for the formation of a BHC. 12 U.S.C. §1841 et seq. A BHC is any "company" that has "control" over any "bank" or over any company that is or becomes a BHC. The BHC Act defines a "company," in part, as a corporation, partnership, business trust, association, or similar organization. Id. at 1841(b). A "bank" includes an "insured bank" under the Federal Deposit Insurance Act that: (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties, and (2) is engaged in the business of making commercial loans. Id. at 1841(c).

Under the BHC Act a company "controls" a bank if: (1) the company directly or indirectly owns, controls, or has the power to vote at least 25 percent of any class of the bank's voting securities; (2) the company controls the election of a majority of the bank's board of directors or trustees; or (3) the Federal Reserve determines after the opportunity for hearing that the company exercises a controlling influence over the bank's management or policies. Id. at 1841(a).

[7] This exception is implemented by the Federal Reserve in Regulation Y of the Federal Reserve's regulations. 12 C.F.R. §225.

[8] 1987 Order, p. 477.

of activities currently conducted by banks . . . ."[9] The Board of Governors also concluded that the "proposed underwriting and dealing activities" were a "proper incident to banking [because they] may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects."[10]

In the orders that the Federal Reserve has issued in connection with the permissible securities underwriting activities of member bank affiliates, the Federal Reserve has expressed concerns about the potential for adverse effects that might result from the proposed activities, such as unsound banking practices, conflicts of interest, unfair competition, undue concentration of resources and loss of public confidence. Because of these concerns, the Federal Reserve has included limitations and conditions in its "Section 20" orders. There were separate protections in the Federal Reserve's original order of which the following are the most significant:

- In determining compliance with capital adequacy requirements, the applicant is required to deduct from its consolidated capital any investment in the underwriting subsidiary that is treated as capital in the underwriting subsidiary.

- The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

- No applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.

- There will be no officer, director or employee interlocks between an underwriting subsidiary and any of the BHC's bank or thrift subsidiaries.

- An underwriting subsidiary will provide each of its customers with a special disclosure statement

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[9] 1987 Order, p. 487.

[10] 1987 Order, p.489.

describing the difference between the underwriting subsidiary and its banking affiliates.

- An affiliated bank may not express an opinion with respect to the advisability of the purchase of the ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

- No applicant or any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period.

- No lending affiliates of an underwriting subsidiary may disclose to the underwriting subsidiary any non-public customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.[11]

[11] 1987 Order, pp. 503-504.

88-397 O - 95 - 8

For Release Upon Delivery
February 28, 1995
11:30 a.m.

TESTIMONY OF

EUGENE A. LUDWIG

COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U. S. HOUSE OF REPRESENTATIVES

February 28, 1995

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Committee, I welcome this opportunity to discuss H.R. 18, the Financial Services Competitiveness Act of 1995. I commend you for so quickly offering an initiative to modernize our financial services system. I also applaud Representative Baker for his thoughtful proposal. Today, artificial and antiquated barriers and restrictions impede the ability of banks, securities firms, and other financial companies to operate efficiently, to provide the range of products and services their customers desire, and to fuel economic growth. Financial services modernization is more than just an interesting idea. It will result in better customer service, more efficient businesses, and a more vital financial services sector for the Nation's economy.

For banks, activities diversification is an essential complement to the geographic diversification authorized by Congress last year. Together, they form the necessary cornerstones for a vigorous banking system. Both types of diversification are needed to ensure that our banks can meet the needs of their local customers and communities as well as remain competitive in international financial markets.

The Secretary of the Treasury has announced several concepts directed toward legislation in this area. He will testify further in this regard shortly. I support the Secretary's approach.

There is much about H.R. 18 that I support. I nonetheless have a number of serious concerns, particularly about those provisions that force banking organizations into rigid structures that will make them less efficient competitors and less effective at meeting the needs of their customers.

I. Maximizing Competition

Mr. Chairman, we agree on the fundamental reason to reform our financial services industry. Allowing banking organizations to expand their activities will lead to improved, more convenient, and less costly services for consumers of financial services--individuals as well as small and large businesses. Competitive financial services markets are the most efficient financial services markets, and thus the best able to serve and benefit all customers.

The benefits of allowing banks to engage in investment banking activities will likely show up most clearly on "Main Street America." A small- or medium-sized business seeking to grow may need to move from traditional bank loans to more sophisticated means of financing, such as the public debt or equity markets. Such a business typically develops a close working relationship with its commercial banker, who may be able to offer useful perspectives as the business seeks to graduate to a middle market. Yet, today, the ability of banks to facilitate a customer's changing

financial needs is limited. Restrictions on the activities of commercial banks deprive that customer of the option to continue to work with a lender knowledgeable about its business when the customer seeks to access the capital markets. The customer is also deprived of the benefits of price and product competition from banks that would otherwise seek its business. The lack of price competition translates into increased financing costs. The lack of product competition limits the availability of innovative financing approaches for businesses.

A more troubling result for a business occurs if its commercial lender cannot serve its evolving financing needs, and no one else will. Small businesses often need amounts or types of financing that nonbank financial institutions have no interest in providing. In these situations, the inability of banks to offer a more comprehensive selection of financing forces some small- and medium-sized firms to perpetuate inappropriate financing arrangements. By harnessing the credit knowledge of the banking system, financial modernization promises these businesses broader access to capital markets.

Increased competition could have benefits for states and municipalities as well. At a time when all levels of government are trying to save money yet preserve essential services, we should offer state and local authorities the benefits of more effective price competition. We have known of these benefits for many years. A 1968 study issued by the Office of the Comptroller of the Currency demonstrated this point clearly.[1] H.R. 18 recognizes this benefit in its provisions allowing greater authority for national banks to underwrite revenue bonds. But I would urge more flexibility in this matter than H.R. 18 provides. Specifically, I would allow national banks to underwrite municipal revenue bonds--as they are today allowed to underwrite municipal general obligation bonds--regardless of whether the bank has a securities affiliate.

In addition, the increased competition provided by banks in these markets will both lower costs to customers and increase (or in some instances create) access to the capital markets for larger businesses.[2] Market access--whether by way of securitization,

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[1] Wm Paul Smith, *Commercial Bank Entry Into Revenue Bond Underwriting: Competitive Impact and Public Benefits* (Washington, D.C.: U. S. Treasury Department, Office of the Comptroller of the Currency, 1968).

[2] Samuel L. Hayes III, A. Michael Spence, and David Van Praag Mark, *Competition in the Investment Banking Industry* (Cambridge, MA: John Wiley & Sons, 1985), pp. 57-58, 274; Richard M. Levich, "A View From the International Capital Markets," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 274; *Modernization of the Financial Services Industry: A Plan for Capital Mobility Within a Framework for Safe and Sound Banking*, Report 100-324, U.S. House of

access to the commercial paper market, or underwriting revenue bonds--will spur economic development. The economic boost that competition in this area provides will translate into increased jobs and will deepen and strengthen our capital markets.

However, I say all of this with one important caveat. None of these benefits will materialize unless new entrants can compete effectively. It is not enough to allow a bank to undertake new activities if, in so doing, we impose so many unnecessary regulatory burdens that we lose the benefits of diversification. If we dismantle the Glass-Steagall wall, we must not leave so much regulatory barbed wire in its place that we defeat our objectives.

This leads me to two fundamental concerns about H.R. 18. First, the bill rigidly compartmentalizes new activities to address safety and soundness concerns. I believe effective safety and soundness oversight requires a more flexible supervisory approach. While any new financial activity entails risk, we must recognize that safety and soundness can increase when banks realize efficiencies from affiliations with other financial services firms.

Second, H.R. 18 shifts new financial services activities--and even some traditional ones--from banks and their subsidiaries to holding company affiliates. Safety and soundness considerations do not require this surgery. It will leave banks atrophied, dependent on affiliate life-support systems. The long-term health of the economy and the banking system depends on banks' ability to remain strong and innovative financial services providers in their own right.

II. Preserving Safety and Soundness

My first concern with H.R. 18 is that the bill relies too heavily on organizational structure and transactional firewalls as supervisory devices to shield institutions from the perceived risks of expanded financial services activities. The bill allows broader

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Representatives, Committee on Government Operations, 100th Cong., 1st Sess. (USGPO, 1987), Appendix, "Supplementary Data on Underwriting Concentration," Exhibits C-1 and G-1, pp. 85, 88; David Neustadt, "Investment Banking Party Ends As Commercial Banks Get Invite," *American Banker*, April 11, 1988, pp. 1, 38-39; Jed Horowitz, "There's Life After Glass-Steagall For Wall Street, Report Says," *American Banker*, December 2, 1987, pp. 3, 8; Thomas A. Pugel and Lawrence J. White, "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities," in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 209; and David S. Kidwell, M. Wayne Marr, and G. Rodney Thompson, "Shelf Registration: Competition and Market Flexibility," *Journal of Law and Economics*, vol. 30 (April 1987), pp. 181-206.

securities activities to be conducted by banking organizations, but (with one exception) only through a bank holding company affiliate. It prohibits other structural options, potentially more efficient or better suited to a particular banking organization, such as the use of bank subsidiaries.

In addition, if banks wish to take advantage of this new opportunity to engage in broader securities activities, they must discontinue activities that are customary, profitable, and that have not been the basis for safety and soundness concerns. For example, a bank could no longer securitize and sell its loans. It could no longer participate in financial market innovations because it would be barred from underwriting and dealing in any securities other than those listed by statute. And banks would have to discontinue their private placement services for institutional customers.

H.R. 18 also contains extensive firewalls that would separate a bank and its securities affiliate to such an extent that it may preclude reasonable opportunities for synergies. These restrictions in many cases would disadvantage a bank securities affiliate relative to an unrelated third party securities firm, placing banking organizations at a competitive disadvantage.

Let me make two further points about relying on organizational structure to limit risk and protect bank customers. First, these devices, as contemplated in H.R. 18, will not deliver the safety and soundness benefits that we need. We cannot depend on them to protect the bank in moments of crisis. In fact, because they are a source of unnecessary costs, they may actually detract from safety and soundness. Second, we have a materially better alternative. A combination of effective supervision and adaptable firewalls can deliver the safety and soundness we need, without excessive costs.

Proponents of the corporate structure approach argue that it promises safety and soundness by insulating the bank from risk. But corporate structure may fail to deliver the insulation from risk that it promises in theory. Experience teaches that the location of an entity in a banking organization's corporate structure, *i.e.*, whether it is a subsidiary of the holding company or of the bank, does not matter when a banking organization decides whether to support its affiliates and maintain its public reputation. For example, where customers or creditors are aware of the relationship between a holding company subsidiary and a bank--and it is highly unlikely sophisticated customers would not be--it is questionable whether a holding company will feel free to walk away from a troubled affiliate, since doing so could hurt the reputation of the bank itself. In the 1970s several large bank holding companies bailed out their failing real estate investment trust affiliates. Just last year, several holding companies came to the rescue of troubled affiliated money market mutual funds.

Proponents of firewalls also contend they are necessary to prevent affiliates from making unlimited draws on the bank's capital and from taking advantage of their affiliates' customers. When applied to certain kinds of activities, these firewalls, along the lines of Sections 23A and 23B of the Federal Reserve Act, and separate capital requirements can play a useful role in reducing a bank's exposure to risk, protecting against conflicts of interest, and preventing consumer abuses. But we must be realistic about their shortcomings.

By far the most crucial shortcoming concerns the effects of overly rigid firewalls on the potential benefits of permitting banking organizations to engage in nontraditional activities. Unduly stringent restrictions could eliminate many of the incentives that motivate banks to enter new activities. Therefore, it would be a mistake to legislatively mandate extensive, detailed, and inflexible firewalls, particularly to broad categories of activities. Rather, supervisors need authority to adapt firewalls to specific activities the conduct of which entail the greatest risks.

For example, it would not, in our view, be appropriate to apply substantial new restrictions because a bank, bank subsidiary, or bank affiliate begins to underwrite state and municipal revenue bonds. Banks have underwritten state and municipal general obligation bonds for years, without ill effects. Why then, should substantial new restrictions be applied when those activities are expanded to include revenue bond underwriting? On the other hand, regulators should be able to provide meaningful firewalls for other activities, such as some or all aspects of property and casualty insurance underwriting.

In contrast to a careful and targeted use of firewalls, the structure H.R. 18 mandates for conducting new activities and operational restrictions are blunt instruments that I fear would undermine key benefits of financial services modernization. If we want a healthy, modern banking system, regulators must have the flexibility to adopt modern approaches to supervision.

Given the widespread doubts regarding the efficacy of structural separateness and the costs involved in establishing a holding company structure, proponents of restricting new activities to holding company affiliates should bear the burden of demonstrating that the holding company structure is the most effective approach to safety and soundness. Otherwise, the market should be free to make its own structural choices to maximize operational efficiency and minimize risk.

Fortunately, we need not depend upon statutorily mandated structural devices to protect against risk. Let me describe the supervisory alternative. In determining whether a banking organization should conduct a particular new activity, the bank

regulator must focus not only on the specific activity but also on the nature of the bank's current activities and on how the bank intends to integrate the new business into its operations. We must be certain the activity is appropriately supervised both by the bank and by its regulator. Relying on supervision, combined with corporate restrictions that fit the specific situations, is superior to relying on mere structural constraints. It allows regulators to tailor the risk management, in light of economic conditions, to the peculiar risks presented by new activities as they are conducted by a particular bank. One-size-fits-all structural constraints and rigid firewalls add nothing to such supervision, and they add little protection in crises.

Placing the emphasis on a combination of supervision and appropriate corporate safeguards is important because it allows us to adopt the kind of management that is necessary for a particular activity conducted in a particular manner. Moreover, supervision and risk control systems, including modeling and stress testing, have improved and become more sophisticated over time and have adapted to the constantly changing ways in which even the same activities are conducted. As banks develop new products, and new ways to synthesize risks, the regulator can adapt its supervisory practices to marketplace developments.

Therefore, safety and soundness depends on more than just risk insulation, and is independent of corporate structure. It is fundamentally determined by how an activity is conducted, how risks are managed, and how an institution is supervised. No matter what corporate structure is in place, strong and effective supervision--which includes appropriate treatment of capital to limit the exposure of the insured institution, and hands-on examination--is crucial to keeping risk in check and protecting the safety and soundness of the banking system and the deposit insurance fund.

III. Structural Choices and Safety and Soundness

My second concern is that H.R. 18's imbalance in favor of activities conducted in holding company affiliates instead of in bank subsidiaries could increase risk and sap the vitality of our banking system. Limiting activities can make banks riskier for several reasons.

First, limiting activities deprives banks of the safety and soundness benefits of diversification. By putting all of their eggs in one basket, it leaves them prey to the vagaries of one market, one set of risks.

Second, limiting activities will prevent banks from evolving beyond a narrow market segment, impairing their ability to continue to do a safe and profitable business. External market forces such as the advent of diverse debt markets and increased

competition from non-bank providers have dramatically shortened the reach and profitability of traditional banking activities, chiefly lending, over the past thirty years.

Third, limiting activities will cause banks to continue to lose their better customers, making even their traditional activities less safe. As competitors rush to develop new products, to learn about the risks of these offerings, and to compete aggressively for bank customers, banks and their subsidiaries will need the ability to provide products to respond to market demands. Accordingly, there should be a strong presumption in favor of allowing new activities to be conducted by bank subsidiaries as well as holding company affiliates where the particular activities do not materially increase the risk of the bank.

The long-term viability of our banking system depends upon the ability of banks (directly and through their own subsidiaries) to be strong and competitive financial services providers in their own right. Key to that result is that banking organizations have reasonable choices regarding the most efficient corporate structure for conducting business. Unless compelled by reasons of safety and soundness--which I do not believe is the case for securities, insurance, and many other financial activities--banking organizations should be allowed to innovate, either through holding company affiliates or bank subsidiaries, as they and the market--not the government--deem appropriate.

Artificial limits and segregation of non-traditional and innovative products and services do not further safety and soundness in our complex and increasingly competitive financial system. Forcing innovation and new product development to occur outside of a bank and its subsidiaries, restricting banks to a very narrow range of familiar activities, would ill-serve the banking system and the Nation's consumers.

Empirical evidence suggests that non-traditional financial activities need not threaten bank safety and soundness. In this regard, let me offer several observations. First, U.S. banks, through foreign branches and subsidiaries, as well as holding company affiliates, have successfully engaged in a variety of non-traditional activities abroad for many years. The authority for this is longstanding.

Second, banks in most G-10 countries have been engaging in a broad range of financial services activities, including the activities specifically referred to in H.R. 18, for many years. Again, no empirical evidence indicates that engaging in these activities has threatened the safety and soundness of these institutions.[3] On the contrary, foreign

[3] The failure of Barings over the past weekend arose from unauthorized derivatives activities. Derivatives activities are within the scope of activities currently permissible for both U.S. and foreign banks and accordingly are not the kind of new activity at issue in Glass-Steagall reform.

bank supervisors have told me that income from non-traditional activities has been a key support to the safety and soundness of certain banks during periods of financial stress.

Third, there is no support for the premise that a bank would bear more risk holding municipal revenue bonds (or other types of securities), for a matter of hours, as part of an underwriting, than it does today when it holds government securities or municipal general obligation bonds, for a matter of hours, in connection with currently permissible bank underwriting activities. Common sense suggests that neither of those market risks is necessarily greater than making and holding a long-term commercial loan.

Finally, the risks to banks from insurance activities are generally no greater than those presented by commercial lending. U.S. banks have offered a variety of insurance services to their customers for many years. They already sell all types of insurance in towns with populations of less than 5,000. They underwrite and sell municipal bond, credit life, accident, and health insurance nationwide.

Recent research also lends support to the conclusion that commercial and investment banking can be combined safely. Scholars have found that the Glass-Steagall Act's separation of commercial and investment banking was not justified either on safety and soundness grounds or as a response to documented problems. In fact, banks with securities affiliates failed less frequently than other banks. A path-breaking 1986 study by Eugene White of Rutgers University found no convincing historical evidence that any of the 9,000 banks that failed between 1930 and 1933 did so as a result of their investment banking activities.[4] It seems the separation between commercial and investment banking largely reflected the continued faith of legislators and regulators in the now-discredited Real Bills Doctrine, which held that making short-term loans for productive purposes and secured by real goods was the only appropriate lending activity for commercial banks. The immediate impetus for passage of the Act came from a serious misdiagnosis of the causes of the banking collapse in the 1930s, together with widespread public resentment toward bankers involved in underwriting and distributing corporate securities.

Another recent study found that the securities underwritten by commercial banks in the years 1921-1933, far from being unduly speculative, tended to be higher in

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[4] E. White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks." *Explorations in Economic History* (January 1986).

quality than those underwritten by investment banks.[5] A detailed study of the hearings preceding passage of the Glass-Steagall Act by George Benston of Emory University found little concrete evidence of the alleged abuses by commercial banks' securities affiliates.[6]

In sum, H.R. 18 represents an opportunity to enhance the safety and soundness of banks. But the ability of banks to seize that opportunity will depend upon the extent to which they can diversify without inefficient and costly structural and supervisory impediments.

IV. Banking and Commerce

You have asked me to comment on the issues involved in permitting commercial firms to own banks. The line between banking and commerce is unclear. Various products and services have attributes of both commerce and banking. Changes in the economy, particularly in the field of technology will further blur the line between banking and commerce. For example, computer programming and information management are now widely acknowledged to be integral to the provision of financial services, even though twenty-five years ago they seemed to be more like pure commercial activities.

Concerns about the consequences of combining banking with pure commercial activities date back to the establishment of the Bank of England, and have included worries about conflicts of interest, excessive market power, and undue risk-taking that might adversely affect depositors, or further threaten the stability and efficiency of the financial system. In the United States, state bank charters have traditionally restricted the powers of banks to engage in such commercial activities. The National Bank Act and the Bank Holding Company Act continue these restrictions for national banks and nonbank affiliates.

Nonetheless, American financial history contains many examples of banks owned by, or otherwise affiliated with, commercial and manufacturing enterprises. The Bank Holding Company Act Amendments of 1970, ended many, but not all, of all those affiliations. Those combinations of banking and commerce did not occasion particular problems or abuses, although many of them involved highly specialized circumstances.

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[5] Randall Kroszner and Raghuram Rajan, "Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933." *American Economic Review.* 84 (September 1994).

[6] George J. Benston, The Separation of Commercial and Investment Banking. (New York: Oxford University Press, 1990).

Clearly, the health and competitiveness of U.S. banking may at some time come to depend on our willingness to modify or dismantle this separation. But further expansion by banking organizations into financial activities offers benefits that are greater and more immediate, and poses risks that are better understood than those associated with combining banking and commerce. At this time, therefore, I would urge that we focus our attention on the universe of financial activities.

V. Conclusion

Any reform proposal must embody three key principles if we are to achieve the full benefits of financial services modernization. First, any new approach must maintain the safety and soundness of the banking system. This requires a balance between prudential safeguards and enhanced activities flexibility, coupled with sound supervision. It does not require presumptions or prohibitions against bank entry into new activities.

Second, a new system should encourage healthy competition and efficient business operations to benefit all consumers of financial services--in all of our communities--and thereby facilitate economic growth. The elimination of artificial barriers to entry and antiquated restrictions on corporate structures is essential to this goal. Like other businesses, banks should have substantial freedom to choose the organizational form that best enables them to respond to marketplace demands, absent compelling public policy reasons to limit that freedom.

Third, regulation--and regulators--must be both effective and efficient. They must not impose unnecessary burdens. In other words, we should not limit the efficiencies resulting from modernization by placing constraints on what activities banks may conduct and how they may conduct them, unless those constraints are clearly necessary to assure safety and soundness or to protect consumers or investors.

In conclusion, I would like to emphasize the importance of these hearings and once again commend your leadership in this area. Absent reform, increasingly competitive world financial markets would imperil the long-term profitability and stability of our banks. Facing up to these issues by reconsidering archaic and counterproductive product restrictions, by removing unnecessary impediments on corporate structure, and by relying on strong supervision of diversified financial firms is, I am convinced, both a wise and necessary course of action.

EMBARGOED
until Feb 28, 11:30 am

Testimony
of
Jonathan L. Fiechter, Acting Director
Office of Thrift Supervision

concerning the

Financial Services Competitiveness Act of 1995

before the

Committee on Banking and Financial Services
United States House of Representatives

February 28, 1995

Office of Thrift Supervision
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I. Introduction

Thank you, Mr. Chairman and members of the Committee, for the opportunity to present the views of the Office of Thrift Supervision on H.R. 18, the Financial Services Competitiveness Act of 1995.

H.R. 18 raises important questions regarding the proper scope of permissible activities for holding company affiliates of banks and thrifts. As the Chairman noted when introducing H.R. 18, the marketplace has changed significantly since the Glass-Steagall Act was enacted over 60 years ago. Since then, a host of new financial products have been introduced, including commercial paper, cash management accounts, mutual funds, mortgage-backed securities, collateralized mortgage obligations, real estate investment trusts, and hedge funds, to name a few.

Millions of Americans now find it perfectly natural to hold part of their savings in the form of uninsured mutual funds or other investment products. Funds that formerly might have been held in a passbook savings account or certificate of deposit are now invested through mutual funds or other investment vehicles in a variety of assets ranging from U.S. Treasury bills to equity or debt issued by foreign corporations and governments.

The financial markets have become national if not global. Corporations can now directly access the financial markets, both as investors and borrowers, bypassing traditional financial intermediaries. The distinction between banks and non-banks engaged in financial intermediation has been blurring over a number of years. By seeking to preserve a compartmentalized set of financial institutions, the Glass-Steagall Act has restricted the ability of U.S. financial intermediaries to respond to market forces, rather than preserving a safe and sound financial system. This is clearly an area where the law has lagged behind the market.

I, therefore, applaud your decision, Mr. Chairman, to hold hearings on this important topic. As you know, there have been a number of studies and Congressional hearings over the years exploring various initiatives to revise the Glass-Steagall Act. These initiatives typically have sought to balance three competing objectives:

1. The need to maintain a safe and sound insured depository system;

2. The need to ensure stable, competitive, efficient and responsive financial markets; and

3. A desire to provide maximum operational flexibility so that various banking and nonbanking financial services can be bundled and offered in an efficient and profitable manner.

To date, none of the Glass-Steagall reform initiatives have been successful in generating the necessary consensus to pass legislation. Issues typically raised by such initiatives include:

- The scope of financial and nonfinancial activities permitted in an entity affiliated with an insured depository institution;

- Whether various financial activities should be permitted to occur within the depository institution or a depository institution subsidiary or should instead be lodged exclusively in the holding company or a nondepository affiliate of the holding company;

- The level of restrictions imposed on credit transactions, marketing, and other relationships between the insured depository institution and its holding company and affiliates;

- The appropriate capital requirements of the insured depository institution, and whether the holding company and/or affiliates should also be subject to capital requirements;

- The type of entity that should be permitted to own a depository institution -- limited to companies engaged primarily in the provision of financial services or broadened to include non-financial companies; and

- How to balance the need for an efficient and sensible supervisory structure that provides for regulatory equality (i.e., functional regulation) with the benefits of having a single regulator responsible for the entire holding company structure.

Your bill, Mr. Chairman, would give bank holding companies important new authority to engage in investment banking and allow investment banks to acquire commercial banks. Other financial and commercial activities, however, would continue to be off limits for bank holding companies. Moreover, the scope of permissible activities of savings and loan holding companies would be sharply curtailed from what is now permitted by statute. Other proposals, such as H.R. 814, the Depository Institution Affiliation Act, introduced by Congressman Baker and others, would create an alternative to the current regulatory systems applicable to bank holding companies and savings and loan holding companies. Well capitalized and well managed companies owning or acquiring banks or thrifts could elect to be regulated under this new system. Companies making the election would be permitted to engage in roughly the same scope of activities currently available to savings and loan holding companies.

In assessing how much flexibility is appropriate, it may be helpful for this Committee to consider the experience of savings and loan holding companies -- which, unlike bank holding companies, have historically been given broad powers. The experience of the Office of Thrift Supervision ("OTS") in regulating these savings and loan holding companies has, on the whole, been positive. Before describing this experience, however, I will provide a brief overview of the differences in the regulation of bank holding companies and savings and loan holding companies, and how those regulatory structures would be altered by H.R. 18.

The views I express today are those of the OTS and not necessarily those of the Administration.

II. OVERVIEW OF DIFFERING REGULATORY STRUCTURES

A. BANKS AND BANK HOLDING COMPANIES

More than 60 years ago, in the aftermath of the stock market crash of 1929 and in the midst of the Great Depression, Congress erected barriers between commercial banking and investment banking. At that time, the country's economic and financial ills, including an alarming number of bank failures, were believed to be due in part to abuses arising out of the relationships between banks and securities firms. During hearings that Congress held in 1931 and 1932, various abuses were identified, including:

- Some banks had placed themselves at risk by making loans to and purchasing securities from their securities affiliates.

- Some banks experienced conflicts of interests between their duties to depositors, customers and shareholders and their desire to promote their securities affiliates.

- Bank officers sometimes held equity stakes in securities affiliates and thus stood to profit personally from bank support of the securities affiliates.

- Securities firms sometimes manipulated the market to support the price of an affiliated bank's stock.

It was in this environment that Congress acted to prohibit bank participation in most forms of investment banking. This was accomplished through four provisions in the Banking Act of 1933, commonly referred to as the Glass-Steagall Act. Those provisions sharply restrict the ability of national and state member banks to engage in securities underwriting and dealing and to make certain investments (§ 16), prohibit affiliations between national and state member banks and companies engaged principally in investment banking (§ 20), restrict management and employee interlocks between national and state member banks and companies engaged principally in investment banking (§ 32), and prohibit persons and entities engaged in investment banking from simultaneously engaging in deposit banking (§ 21).

Twenty-three years after Glass-Steagall was enacted, additional restrictions were placed on the activities of bank holding companies. During the early 1950s, the dramatic expansion of the scope of activities of several large multiple bank holding companies (i.e., holding companies owning more than one bank) raised concerns. Congress worried that affiliations between large banking networks and large commercial enterprises might result in too much concentration of economic power. For example, banks affiliated with large commercial enterprises might give priority to the operations of their affiliates, thereby making it more difficult for nonaffiliates to obtain credit and other banking services. In addition, commercial affiliates of banks might be able to obtain loans on more favorable terms and thereby gain a competitive advantage over nonaffiliated companies. Congress was also concerned that affiliations between banking and commerce could lead to the same types of conflicts of interest, self-dealing, and tying arrangements that motivated passage of Glass-Steagall. As a consequence, Congress enacted the Bank Holding Company Act of 1956, which, among other things, restricted the scope of permissible activities of multiple bank holding companies and their subsidiaries to those that are "closely related" to banking.

More than a decade later, in 1970, as unitary bank holding companies (i.e., one-bank holding companies) grew in size, Congress became concerned that these companies too might begin to amass undue economic power and present similar public policy concerns when affiliating with commercial enterprises. Thus, to guard against possible future abuses, Congress extended to unitary bank holding companies the same activities restrictions that had been imposed on multiple bank holding companies in 1956.

The practical effect of the Bank Holding Company Act, as enacted in 1956 and amended in 1970, is to prevent companies engaged in commercial, industrial and certain financial

activities (such as general insurance underwriting) from acquiring banks. These prohibitions were added on top of the investment banking restrictions already imposed by the Glass-Steagall Act.

B. SAVINGS AND LOAN HOLDING COMPANIES

In 1959, shortly after enactment of the Bank Holding Company Act, Congress enacted the Savings and Loan Holding Company Act (technically, the Spence Act), which imposed a moratorium on acquisitions of additional insured institutions by existing savings and loan holding companies and prohibited newly-formed savings and loan holding companies from acquiring more than one insured institution. The purpose of this Act was to halt the growth of multiple savings and loan holding companies until Congress had an opportunity to determine whether additional regulation was needed.

The moratorium remained in effect until 1968, when the Savings and Loan Holding Company Amendments of 1967 terminated the moratorium, but restricted the permissible activities of multiple savings and loan holding companies to those specified by the statute, plus any additional activities authorized by applicable regulations. The practical effect of these amendments was to prohibit multiple savings and loan holding companies from engaging in commercial and industrial enterprises, as well as certain financial activities such as underwriting insurance or securities.

Similar restrictions were <u>not</u> imposed on unitary savings and loan holding companies. Unitary savings and loan holding companies were, and are, permitted to engage in any activities that do not threaten the safety and soundness of their subsidiary savings associations or have the effect of enabling a savings association to evade applicable laws or regulations. Beyond this, no restrictions were, or are, imposed on the scope of permissible activities of unitary savings and loan holding companies.

Even when Congress amended the Bank Holding Company Act in 1970 to impose restrictions on unitary bank holding companies, no additional restrictions were placed on unitary savings and loan holding companies. Although the Congressional committee reports issued in 1970 do not explain why unitary savings and loan holding companies were treated differently, this was most likely because savings associations are required by law to focus on residential lending. As a result, affiliations between savings associations and companies engaged in financial and other commercial enterprises do not present the same potential for amassing commercial power.

This analysis appears to be borne out by amendments made to the Savings and Loan Holding Company Act in 1987, when Congress added the specific requirement that savings association subsidiaries of unitary savings and loan holding companies must meet the

qualified thrift lender test in order for such companies to retain their broad powers.[1] Under the qualified thrift lender test, savings associations must invest at least 65% of their assets in residential mortgage loans and certain other designated assets. Thus, the broader powers of savings and loan holding companies have traditionally been linked to the residential lending focus of savings associations. In exchange for investing in depository institutions that are prohibited by the federal government from engaging in unrestricted commercial lending, savings and loan holding companies have been permitted to engage in a broader range of activities than bank holding companies.

Nearly all savings and loan holding companies in existence today qualify for the broad powers authorized by the Savings and Loan Holding Company Act. As a result, these companies are generally permitted to engage in the following activities:

- Activities closely related to banking (e.g., lending, data processing, securities brokerage, investment advice);
- General securities underwriting and dealing;
- Other financial services;
- Real estate development; and
- Commercial and industrial enterprises.

When conducting the foregoing activities, however, savings and loan holding companies must comply with a variety of strict statutory and regulatory requirements and restrictions. Savings and loan holding companies also must undergo regular OTS examinations, usually concurrent with the examination of their subsidiary thrifts. These safeguards are intended to prevent the same abuses that motivated passage of the Bank Holding Company Act and the Glass-Steagall Act. Instead of broad-brush activities prohibitions, however, the Savings and Loan Holding Company Act employs specific and targeted requirements and restrictions, including:

- Companies must obtain OTS approval before acquiring a savings association. The OTS does not approve any acquisition that it believes would be detrimental to a

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[1] Congress also added a provision authorizing multiple savings and loan holding companies to engage in the same activities as are permissible for unitary holding companies provided all, or all but one, of the holding company's subsidiary savings associations were in troubled financial condition when acquired and all of the subsidiary savings associations meet the qualified thrift lender test.

savings association, the savings association's community, or the federal deposit insurance funds.

- Savings and loan holding companies are required to submit periodic reports (annually and quarterly) to the OTS providing information regarding, among other things, subsidiaries, investments in affiliated savings associations or savings and loan holding companies, management, outstanding securities, legal proceedings and materially important events.

- Transactions between savings and loan holding companies and their savings associations are subject to strict statutory restrictions. For example, savings associations are prohibited from purchasing securities issued or being underwritten by any affiliate and from making loans to any affiliate engaged in activities that are not permissible for bank holding companies; the aggregate dollar amount of transactions that a savings association may engage in with all affiliates is restricted to 20% of a savings association's capital and surplus; and all transactions between a savings association and its affiliates must be on arms' length terms.

- Savings associations that fail to maintain adequate capital are prohibited from paying any dividends to their holding companies. Dividend restrictions are also placed on well capitalized and adequately capitalized savings associations. Moreover, all savings associations are required to give the OTS at least 30 days notice before declaring any dividend to a holding company.

- Savings associations are prohibited from requiring that a customer that obtains a loan or other service from them must also obtain some other service from the association or any affiliate, subject to certain narrow exceptions.

- The OTS also imposes case-specific restrictions on the operations of companies that acquire savings associations. For example, when securities firms acquire savings associations, the OTS routinely imposes special conditions that require the savings association and the securities firm: (i) to maintain separate corporate identities for all purposes, including their dealings with the public, and to refrain from intermingling business transactions, accounts or records, (ii) to ensure that their respective officers and directors are aware of and abide by OTS policy statements on conflicts of interest and usurpation of corporate opportunity, and (iii) to comply with OTS policies and regulations governing retail sales of nondeposit investment products and sales of securities.

Taken together, the foregoing safeguards have worked well to prevent the types of systemic abuses that motivated passage of the Glass-Steagall Act and the Bank Holding Company Act.

C. CHANGES PROPOSED BY H.R. 18

H.R. 18 would amend the Glass-Steagall Act and the Bank Holding Company Act to permit affiliations between commercial banks and investment banks. Adequately-capitalized and well-managed bank holding companies that own well-capitalized and well-managed banks could acquire affiliates engaged in a variety of securities activities, including underwriting and dealing. In order to limit bank exposure to the risks arising from these securities activities and to protect bank customers against conflicts of interest, these affiliations would be subject to a variety of safeguards or "firewalls" not unlike many of those that currently apply to savings and loan holding companies that engage in securities activities. The firewalls would, for example, prohibit banks from:

- Extending credit to a securities affiliate;
- Purchasing the assets of a securities affiliate;
- Enhancing the marketability of securities underwritten by a securities affiliate (by issuing a guarantee, for example);
- Extending credit to cover an obligation (principal, interest or dividends) of an issuer whose securities are underwritten by a securities affiliate;
- Providing investment advice on securities underwritten by a securities affiliate absent disclosure of the affiliation; or
- Disclosing nonpublic customer information to a securities affiliate.

Because of the current broad powers authorized by the Savings and Loan Holding Company Act, the impact of H.R. 18 on savings and loan holding companies would be quite different than on bank holding companies. For bank holding companies, H.R. 18 would grant important new powers. For savings and loan holding companies, however, H.R. 18 would significantly restrict powers.

H.R. 18 would amend the provisions of the Savings and Loan Holding Company Act that currently authorize most savings and loan holding companies to engage in diverse business activities. As amended, these provisions would apply only to savings and loan holding companies in existence on January 4, 1995. All companies acquiring savings associations after that date would be restricted to those limited activities that have been approved by statute for multiple savings and loan holding companies, plus activities approved for bank holding companies.

In other words, on a going forward basis, companies engaged in commercial, industrial, and certain financial enterprises (such as insurance underwriting) could no longer acquire savings associations. In addition, savings associations that do not now have holding companies -- which represents almost two-thirds of all savings associations -- would be precluded from forming holding companies that engage in these activities. Thus, under H.R. 18, the permissible scope of activities of a savings and loan holding company would vary radically depending upon whether the holding company was established after January 4, 1995.[2]

The table below compares current bank and thrift holding company powers to those proposed by H.R. 18, as well as those proposed by H.R. 814.

Permissible Activities	BHCs Now	SLHCs Now	HR 18 BHCs and SLHCs	HR 814 BHCs and SLHCs
Closely Related Activities	Yes	Yes	Yes	Yes
General Investment Banking	No	Yes	Yes	Yes
Other Financial	No	Yes	No	Yes
Real Estate	No	Yes	No BHCs; Yes SLHCs	Yes
Commercial/Industrial Activities	No	Yes	No	Yes

Office of Thrift Supervision, February 1995.

[2] The OTS is still reviewing changes made to H.R. 18 late last week and may submit additional comments for the record once our review is complete.

III. OTS EXPERIENCE WITH SECURITIES COMPANIES AND COMPANIES ENGAGED IN OTHER FINANCIAL AND COMMERCIAL ENTERPRISES

As noted above, companies engaged in a broad range of business activities have long been permitted to acquire savings associations. Thus, a review of the experience of savings and loan holding companies may provide some insight regarding two key issues: (a) whether depository institutions can safely affiliate with securities firms; and (b) whether depository institutions can safely affiliate with other types of financial, real estate, commercial and industrial firms. Of course, the commercial lending powers of savings associations are sharply restricted, whereas those of commercial banks are not. Thus, combining banking and commerce may present issues not raised by combining the business of thrifts and commerce.

Today, the OTS supervises slightly over 1,500 savings associations. Six hundred and fifty, or over one-third of these institutions, are controlled by savings and loan holding companies. These 650 savings associations hold $540 billion in assets, which represents 70% of all savings association assets.

In its capacity as regulator of savings and loan holding companies, the goal of the OTS is to ensure that holding companies do not harm their savings association subsidiaries. We are concerned with the general condition of the holding company and the nature of its activities only to the extent these factors may affect the financial condition and safety and soundness of its subsidiary savings association. Accordingly, our examinations of holding companies focus primarily on:

- Transactions between holding companies (and their affiliates) and their savings associations;
- Fund distributions from savings associations to their holding companies (e.g., dividends and tax payments);
- The quality of holding company management and the extent of management's participation in and oversight of thrift decisions; and
- The financial impact, if any, of the holding company's operations on the subsidiary thrift.

When a particular activity conducted by a holding company affiliate is unrelated to the operations of the savings association and the affiliate has no dealings with the holding company's thrift, then OTS is not typically concerned with the operations of the affiliate.

The OTS does not routinely compile aggregate statistics regarding the number of savings and loan holding companies that engage in activities unrelated to the thrift. A recent OTS survey, however, of the activities of the top 25 savings and loan holding companies (measured by the amount of thrift assets held) indicates that about one-quarter of these companies engage in some type of financial, commercial or industrial activity that would be precluded by H.R. 18 for new savings and loan holding companies.

The roster of savings and loan holding companies includes many small holding companies engaged exclusively in activities closely related to owning and managing a subsidiary thrift, but also a number of multi-national, multi-billion dollar companies engaged in diverse financial, commercial, and industrial activities. In between are numerous medium-size companies that engage in a few select diversified activities.

There certainly have been occasions when savings and loan holding companies along with their subsidiary thrifts have violated the law or otherwise engaged in unsafe and unsound practices that required enforcement action. We have not, however, detected any systemic problems that arise from the scope of permissible activities of savings and loan holding companies and their affiliates. In our experience, savings and loan holding companies that engage in diverse activities do not raise supervisory concerns with greater frequency than savings and loan holding companies that confine their activities to those permissible for bank holding companies.

Nor have we seen evidence, in the thrift context, of the types of systematic abuses that motivated enactment of the Glass-Steagall Act and the Bank Holding Company Act. We attribute this to the many safeguards that regulate interaction between savings associations and their holding companies -- and perhaps also to the unique nature of the thrift business, with its focus on residential mortgage lending.

Thus, for example, concerns that a savings association may be placed at risk because of loans or dividends to, and purchases from, a holding company engaged in diverse activities are addressed by the statutory and regulatory restrictions governing the type, amount and character of a savings association's transactions with its affiliates. As already noted, savings associations are flatly prohibited from making loans to any savings and loan holding company engaged in any activities that would be impermissible for a bank holding company. Dividends are also closely regulated.

Concerns about potential conflicts of interest and about customers being required to utilize products and services offered by affiliates of a savings association are addressed by the statutory anti-tying provisions described above.

Concerns about self-dealing by management are addressed by, among other things, the laws regulating fiduciary duties, management interlocks and transactions with affiliates.

Concerns about undue concentration of commercial power are reduced by the restrictions placed on the lending activities of savings associations, which require a residential lending focus.

It is our belief that affiliations between savings associations and companies engaged in financial, commercial and industrial activities have raised neither systemic safety and soundness nor public policy concerns. Indeed, in our experience, these affiliations have had three primary benefits. First, savings and loan holding companies that engage in diverse lines of business often have substantially greater financial resources than nondiversified companies. Diversified companies have infused several billion dollars in equity capital into savings associations. Often these infusions are made well after initial acquisition to support expanded customer services and maintain capital. These infusions of capital have decreased taxpayer exposure to federal deposit insurance losses.

Second, although less quantifiable, it has been our experience that diversified companies can contribute business and managerial talent and expertise to their subsidiary savings associations. This is especially true when holding companies have significant experience in financial services activities.

Third, when savings associations affiliate with holding companies engaged in providing financial services, the savings association, its holding company, and their customers all benefit. Customers benefit when they are able to do business with an integrated financial services company. Savings and loan holding companies may be in a position to offer customers "one-stop shopping" for all their financial needs. In a single phone call or single stop, customers are able to access insured deposits, investments and insurance.[3]

The advantages to customers, however, go beyond the convenience of "one-stop shopping." Because customers may look to the company and its affiliates to meet most of their financial needs, the company and its affiliates become quite familiar with their customers. Thus, for example, when a customer applies for a loan from the company's savings association, the savings association may be able to confirm quickly the customer's credit history and financial standing with an affiliate. As a result, loan approvals may occur much more rapidly. The operation of an integrated family of financial companies may also enable a company to assemble sufficient expertise and resources to develop cutting-edge products and achieve economies of scale that reduce costs to customers.

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[3] In situations like this, savings associations are required to follow special procedures to ensure that customers understand the differences between insured deposits and uninsured products. Statutory anti-tying provisions also must be observed.

In short, if savings and loan holding companies are prohibited from providing broad-based financial services, there will be fewer companies in the marketplace competing to provide consumers with better products and better service at better prices.

IV. CONCLUSIONS

For these reasons, I believe that the experience of savings and loan holding companies provides concrete evidence that depository banking activities and securities activities can work together in a safe and sound manner, provided adequate safeguards are established. Savings associations have long been affiliated with securities firms without any adverse systemic repercussions. Indeed, for the reasons explained above, these affiliations have often proven beneficial to the thrift and to their customers.

For these same reasons, I also urge that savings and loan holding companies not be stripped of their existing statutory authority to engage in other financial activities and various commercial and industrial activities. Although this Committee may not be prepared to extend the savings and loan holding company model to all of banking, many years of experience under the Savings and Loan Holding Company Act has demonstrated that, for savings associations, this is a model that works extremely well.

At a time when both the Administration and Congress are committed to reducing regulatory burden, H.R. 18 raises the question of whether savings and loan holding companies should be subjected to a new overlay of government restrictions. If the benefits of the thrift charter continue to be eroded while all the unique restrictions and costs that the government places on the thrift charter are retained, it will become much more difficult to attract capital to the thrift industry, with potentially serious consequences.

This would be especially unfortunate at a time when the thrift industry is facing an uncertain future. The dramatic expansion of the government-sponsored secondary mortgage market has narrowed interest margins on conventional fixed-rate mortgages, a major product of the thrift industry. The significant financial burdens imposed directly and indirectly on surviving savings associations as a consequence of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 have further reduced profitability. Well capitalized and well managed savings associations are facing deposit insurance premiums six times higher than well capitalized and well managed banks.

At a time like this, I believe it is beneficial to provide savings associations with continued access to the financial and managerial resources available through broad-based savings and loan holding companies.

APPENDIX

March 1, 1995

**STATEMENT OF
THE HONORABLE ROBERT E. RUBIN
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

March 1, 1995

Chairman Leach, Mr. Gonzalez, and Members of the Committee. I am pleased to be here today with Deputy Secretary Frank Newman to discuss the Administration's views on repealing the Glass-Steagall Act and modernizing our financial system. Both of us have had long, hands-on experience in the matters before this Committee today; we've both worked diligently on the proposals under consideration; and both of us are committed to a productive dialogue with Congress on financial modernization. So while I shall proceed with the opening statement, I hope Members of the Committee will look to both of us for comments in the subsequent discussion.

I want to note at the outset that we are encouraged to see the Committee move with dispatch to address major issues of financial reform. I want to congratulate you, Mr. Chairman, and other members of the Committee, for introducing alternative approaches to financial modernization that will serve us well in

framing the discussion and developing balanced, constructive legislation. Indeed, as I shall discuss shortly, the Administration's approach to financial modernization has several key elements in common with H.R. 18, as well as some with H.R. 814. But I want to say up front, that we do not endorse removing current restrictions on combinations of banking and commerce.

I also want to commend the Committee for the strong, bipartisan support it provided in the past Congress for such important banking legislation as authorizing interstate banking and branching, providing the funding needed to complete the clean-up of the thrift industry, establishing the community development financial institutions program, and reducing needless regulatory burdens. By continuing in this bipartisan manner, I believe we have an opportunity to enact historic reform of our financial system.

More generally, I note that this is the first time in many years that any Secretary of the Treasury has testified on Glass-Steagall reform against the backdrop of a healthy, stable U.S. financial system.

Let me turn now to a discussion of the issues before us today. First, I will briefly discuss why financial modernization is needed. Second, I will outline our views on the objectives and nature of financial modernization. Finally, I will address

some specific elements of H.R. 18, the Financial Services Competitiveness Act of 1995. In this respect, I want to note that, as you know, there have been some very recent changes to H.R. 18 that have made it difficult for us to comment on some of the specifics in the time available for this hearing. We realize that this is an ongoing process, and look forward to working with you as the legislation evolves.

The Case for Financial Modernization

Financial modernization as we refer to it here is commonly understood to mean reform or repeal of the Glass-Steagall Act and the insurance provisions of the Bank Holding Company Act, expanding the permissible activities of banking, securities, and other financial service organizations, and otherwise providing for a more flexible and efficient financial services system. The case for financial modernization has been made repeatedly over recent years in academic studies, government reports, and congressional hearings. But most importantly, the case continues to be made daily by the realities of the financial services marketplace.

Briefly put, the segmentation of financial markets and institutions envisioned in our current law does not correspond to what is happening around us.

Commercial banks now compete vigorously with securities firms, mutual funds, and insurance companies for the funds of savers; and banks can no longer rely on traditional loans as their primary source of growth and profitability. Banks have responded by introducing new products and services intended to generate fee income and by expanding to the limited extent permitted by law into markets related to their basic business, such as insurance, securities, and mutual funds. Still, among major financial services providers, banks remain the most restricted in their structure and activities. This prevents them from choosing the most efficient organizational structure for their particular markets; and it prevents them from fully responding to the needs of their customers with the products and services customers demand.

Like banks, other providers of financial services have diversified over the years, in many cases by introducing bank-like products and services. For example, insurance company commercial and mortgage loans substitute for bank loans, while their insurance policy premiums compete for savers' funds. In addition, securities firms offer cash management accounts that substitute for commercial bank deposits and they issue credit cards. Securities firms are also active in making commercial loans, either directly or as loan syndicators. Finally, securities firms compete with banks in markets for commercial paper, private placements, and securitized assets. Nevertheless,

securities firms have not had the opportunity to offer their customers a full range of financial services, including commercial banking, as their international competitors have been doing for many years.

It seems to us that the evidence of real markets argues in a very compelling way for creating a much more rational framework for financial services. The most obvious starting point should involve a closer look at those financial services providers most similar to commercial banks, that is, securities and insurance companies.

The Glass-Steagall Act

Glass-Steagall was enacted in 1933 to restrict banks' securities activities and affiliations, and was long seen as having separated commercial banking from investment banking. Against the background of the Great Depression, supporters argued that the Act was necessary to protect banks, prevent conflicts of interest and other abuses, and safeguard the financial system. Since then, defenders of Glass-Steagall have also argued that we need the Act to protect the federal deposit insurance system.

However, the banking industry today is fundamentally different from what it was two decades ago, let alone in 1933. The business of banking has been transformed, in the U.S. and in

other industrialized countries, from a relatively local business of taking deposits and making loans to a national and global business of facilitating capital formation through diverse new products, services, and markets. This has been long recognized in parts of Europe, where banking organizations traditionally engage in full service investment and commercial banking activities. Moreover, U.S. banks generally engage in a broader range of securities activities abroad than is permitted domestically.

Even domestically, the separation of investment banking and commercial banking envisioned by Glass-Steagall has eroded in significant respects. As you know, banking organizations can already: underwrite and deal in U.S. government and agency securities, general obligation municipal bonds, agency-guaranteed mortgage-backed securities, and certain industrial development bonds; conduct private placements (including commercial paper placements), securitize loans they have originated or purchased, provide discount and full service brokerage services, offer financial advisory services, and serve as investment advisers.

In addition, beginning in 1986, the Federal Reserve has permitted bank holding companies to establish nonbank subsidiaries to engage in a variety of otherwise prohibited, or "ineligible," securities activities -- including underwriting and dealing in debt and equity -- as long as the subsidiary is not

principally engaged in such activities. And under the Savings and Loan Holding Company Act of 1967, unitary savings and loan holding companies have been able to engage in investment banking activities. Also, the International Banking Act of 1978 grandfathered the securities activities of a number of foreign banks. Finally, a number of states permit state-chartered bank affiliates to engage in securities underwriting beyond that permitted national banks, and the FDIC has continued to allow state nonmember banks to have subsidiaries engaged in these activities.

These developments point to the extensive involvement depository institutions already have in investment banking and the experience they and their supervisors have gained in managing these activities. At the same time, it should be recognized that securities firms, too, have gained substantial experience in managing the bank-like activities discussed earlier. But the inability of securities firms to affiliate with commercial banks impairs their ability to deliver these financial services as efficiently as possible.

As a result of these market realities, we can clearly see a convergence of commercial and investment banking. This convergence renders any legal separation of commercial and investment banking increasingly awkward and artificial. In this environment, Glass-Steagall imposes unnecessary costs on the

financial system. It makes providing financial services less efficient and more costly. It can conceivably impede safety and soundness by limiting revenue diversification. And it results in lost opportunities to provide more integrated, convenient financial services to consumers and communities.

Moreover, while we recognize the legitimacy of the concerns that led to enactment of Glass-Steagall, we believe those concerns are adequately addressed outside of the Act. For example, numerous steps have been taken over the years to safeguard against risky and abusive bank transactions and to protect the deposit insurance fund. For example, Sections 23A and 23B of the Federal Reserve Act restrict transactions between banks and their affiliates. At the same time, Congress has enacted significant reforms for the express purpose of protecting the deposit insurance fund. The most important of these is prompt corrective action, under which the regulators are required to move rapidly to resolve problems at depository institutions with insufficient capital. Other reforms include risk-based deposit insurance premiums and least-cost resolution of failed institutions.

In addition, it is difficult to argue that the security underwriting risk of an investment bank is greater than the loan making risk of a commercial bank. In both cases, risk increases with the length of time the asset is held, but underwriters

typically distribute underwritten securities as rapidly as possible while a commercial bank may hold a loan for its full (and lengthy) term to maturity. Importantly, various studies have found that (1) of the numerous bank failures in the early 1930s there is no convincing evidence of failure caused by bank investment banking activities; and (2) the difference in the average risk and return for the two industries is not nearly as great as variations in risk and return within those industries. This suggests that combining these activities will not introduce unacceptable levels of risk to the financial system.

Insurance Activities

Both national and state commercial banks, and bank holding companies, typically have been limited to a modest range of insurance activities. National banks are permitted to underwrite and sell credit life, accident, and health insurance. They may also sell annuities and municipal bond insurance, lease space and sell customer lists for insurance activities, and share in the resulting sales commissions. The National Bank Act expressly authorizes national banks located in towns of 5,000 or less to sell a broad range of insurance. The OCC has interpreted this authority to permit a national bank located in a qualifying town to sell insurance nationwide through that office, and that interpretation has been upheld.

Bank holding companies and their subsidiaries generally are prohibited from selling insurance, although exceptions permit bank holding companies to engage in limited insurance activities similar to those permitted national banks. The expansion of banking and insurance has been undertaken most broadly at the state level, but even there the primary emphasis remains on distribution.

Like securities, insurance activities bear important similarities to banking. Insurance companies collect premium payments as banks collect deposits; insurance companies intermediate funds received into loans and investments as do banks; insurance companies eventually repay their policyholders as banks repay their depositors; and insurance companies sell their products through local office networks as do banks. Because of these similarities, there is a strong case that permitting affiliations between banking and insurance companies offers opportunities for significant economies of scope and scale for the institutions, as well as significant benefits to consumers in the form of greater convenience and potentially lower costs.

For these reasons, we believe that current restrictions on affiliations between banks and insurance companies are outdated and overly restrictive. At the same time, we are mindful of the varying degrees of risk that accompany different types of

insurance activities. For example, underwriting life insurance presents less risk than does underwriting certain lines of property and casualty insurance. The structural framework for financial modernization should provide for ways to deal with these facts. In our view, insurance affiliation is important to both banks and consumers. The latter, especially, can benefit significantly from the greater availability and potentially lower cost of critically needed insurance products in small towns and local urban communities.

International Considerations

The case for financial modernization is made even stronger when international financial markets are taken into consideration. Currently, the U.S. financial system is the most restrictive of the developed economies in the limits it places on the structure and affiliations of financial institutions. Many other countries with well-developed financial systems permit more comprehensive combinations of banking and other forms of finance, as well as varying degrees of banking and commerce. In the eyes of some, the European Community set the trend for the future through the Second Banking Directive. The latter permits banks to engage directly in full service securities and commercial banking services throughout the Community. In fact, in 1990, the Task Force on the International Competitiveness of U.S. Financial Institutions of the Committee on Banking, Finance and Urban

Affairs suggested that the European Community's pending reform "would be comparable to the removal of Glass-Steagall, McFadden, the Bank Holding Company Act, and many state laws and regulations in the United States."

In conclusion, full service financial firms in Europe will benefit from the economies of scope that go with joint production of complementary products; and they will benefit from the economies of scale that go with more efficient use of their financial services distribution systems. The result should be financial institutions with higher, more stable profits that are better able to attract capital and compete ever more effectively on a global basis. A more modern legal framework -- one that recognizes the enormous changes over the past decade -- can make U.S. banks, securities firms, insurance companies, and other financial firms more competitive in the international marketplace. In short, as U.S. financial services providers become stronger at home they will become stronger abroad.

Administration's Views on Financial Modernization

The Administration's approach to financial system reform has five key objectives: First, promoting efficiency and competition -- and better service for users -- by eliminating unwarranted restrictions on financial services providers. Second, ensuring the safety and soundness of FDIC-insured depository institutions

and the federal deposit insurance funds. Third, encouraging market discipline and avoiding extension of the federal safety net. Fourth, providing effective oversight of the affiliations and activities in question. Fifth, advancing competitive equality -- promoting a fair and competitive business environment. And, sixth, making U.S. financial services providers stronger at home so they will be better able to compete abroad.

We would like to point out, however, that financial modernization should be viewed as an evolving process. Certain measures taken now do not preclude taking additional steps later, when we will have the benefit of even more industry and regulatory experience. It is absolutely essential that the banking system maintain safety and soundness. The overall goal is to achieve needed change without adding undue risk to the deposit insurance system. In our view, properly structured product diversification should increase the safety and soundness of the financial system.

With this in mind, I would now like to discuss our approach to financial modernization, an outline of which is attached to this statement.

The Basic Approach

As a general matter, we would permit an FDIC-insured depository institution to affiliate with a securities firm, insurance company, or other financial company. We would likewise permit such a company to affiliate with an insured depository institution.

The permitted affiliations could be done by allowing the affiliated company to be a subsidiary of the insured depository institution or the institution's parent company. The choice of corporate structure would be a private business decision.

Also, for the reasons discussed in detail earlier, we would repeal Section 20 of the Glass-Steagall Act and the insurance restrictions in the Bank Holding Company Act. Section 20 generally prohibits a bank that is a member of the Federal Reserve System from being affiliated with a company that is principally engaged in underwriting or dealing in securities that a national bank cannot underwrite or deal in directly. Doing this will prove especially beneficial to small and medium-sized businesses that typically rely on banks for their short-term credit needs. Local banks know these companies well but are currently unable to meet all of their capital financing needs because they cannot provide a full range of equity services. Permitting these affiliations should give small businesses, who

generally have no access to Wall Street, a significant source of new, low-cost capital.

The Bank Holding Company Act includes restrictions on bank holding companies' insurance activities. Repealing these restrictions would clear the way for insurance companies and banks to affiliate. This should be especially beneficial to consumers, as discussed earlier.

Qualifying for New Affiliations

Under our approach, insured depository institutions could affiliate with firms that underwrite securities or insurance that a national bank cannot underwrite directly only if regulators find that:

- the institutions are well-capitalized and well-managed (and any holding company subject to capital standards meets those standards);
- the institutions and their affiliates have internal controls adequate to manage financial and operational risk; and
- the affiliation would be unlikely to impair the institutions' safety and soundness.

Moreover, we would permit such affiliations to be established only with capital over and above what the insured depository institution or holding company needs to meet its own capital standards. And we would prohibit continued affiliation between an insured depository institution and an affiliate engaged in securities or insurance underwriting not permissible for a national bank, if the institution (or any of its insured depository affiliates) remains undercapitalized for more than six months (or with regulatory approval, for an additional 18 months).

Safeguards

We believe it is important that insured depository institutions' affiliates do not become a source of weakness to the institutions. For that reason, we would maintain the regulators' authority to impose consolidated capital standards on bank holding companies whose subsidiary insured depository institutions constitute their principal business by comprising at least half of the bank holding companies' total assets.

Consolidated capital standards can serve as a measure of the health of the overall organization -- and thus reduce the chances that affiliates' weakness would pose unacceptable risks to insured depository institutions. But applying consolidated capital standards to highly diversified financial services

organizations may not be appropriate or meaningful (e.g., in view of differences in prevailing capital levels from one industry to another). Accordingly, under this proposal, such standards would remain discretionary, and a new interagency coordinating committee would determine under which circumstances such standards would apply to holding companies that have less than half of their assets in insured depository institutions. Currently, insured depository institutions typically account for most of the assets of bank holding companies. Under this proposal, the Federal Reserve Board would continue to administer the Bank Holding Company Act for all bank holding companies.

We also would maintain the authority of insured depository institutions' primary federal regulators to verify and enforce compliance with restrictions on the institutions' transactions with affiliates. And we would require federal regulators to coordinate institutions' examinations so as to prevent such abuses as shell games, as well as to minimize overlap. This would complement existing law requiring regulators to coordinate examinations so as to reduce regulatory burden.

Firewalls. The term "firewalls" typically refers to certain regulatory and statutory restrictions on transactions between an insured depository and its affiliates for the purpose of protecting the safety and soundness of the insured institution or preventing abusive practices. As a general matter, we believe

that firewalls should be effective but not excessive, and believe that those objectives can be reasonably achieved. The overall goal is to protect the insured depository as necessary, without needlessly negating the synergies of combining a variety of financial activities.

The requisite flexibility and balance should be achievable by employing a combination of (1) rules (e.g., an insured depository institution may not generally extend credit to its securities affiliate, or issue guarantees for the purpose of enhancing the marketability of securities being underwritten by the securities affiliate); and (2) directives to regulators (to deal with the following practices not by general prohibitions but by requiring regulators to prescribe appropriate regulations designed to prevent the practices from causing problems: the institution and securities affiliate's having officers or directors in common; and extensions of credit by an insured depository institution to pay principal, interest, or dividends on securities underwritten by a securities affiliate).

We also would require appropriate disclosure so that customers do not confuse uninsured products with insured deposits; and we would require measures to protect confidential customer information.

Additional safeguards. We would apply additional safeguards to insured depository institutions controlled by companies that are not subject to consolidated capital standards. These additional safeguards would require the insured depository institutions to be well-capitalized; and they would require any institution that ceases to be well-capitalized to submit an acceptable capital restoration plan within 60 days, and permit regulators to accept the plan only if each company that controls the institution guarantees the institution's compliance with the plan. If the institution fails to comply with the above requirement, we would require orderly divestiture of the depository institution within one year, and authorize regulators to require earlier divestiture if necessary to keep the institution safe and sound. The requirement of a capital restoration plan and parent company guarantee parallels the current "prompt corrective action" statute -- but uses "well-capitalized" (rather than "adequately capitalized") as the standard.

Two-Way Street

To achieve true competitive equity and opportunities for efficiency and competition, we would permit companies engaged in financial activities to affiliate with insured depository institutions, just as insured depository institutions are permitted to affiliate with such companies. We would also allow

an affiliate of an insured depository institution to hold a diversified portfolio of investments in nonfinancial firms made in the course of the affiliate's merchant banking or venture capital activities. We would limit such investments in the aggregate to an appropriate level such as 5 percent of consolidated assets.

Other related measures should include simplifying the Bank Holding Company Act (e.g., to streamline the current application process, and avoid applying to diversified financial services firms detailed rules for the conduct of activities). Correspondingly, we agree with Chairman Leach and Representative Baker that it would be appropriate to rename both the Act and bank holding companies the Financial Services Holding Company Act and financial services holding companies, respectively.

Functional Regulation

Functional regulation refers to a regulatory process in which a given financial activity is regulated by the same regulator regardless of who conducts the activity. The purpose is to bring greater order and efficiency to the regulatory process. To advance this approach, we would limit banks' current exemption from SEC broker/dealer registration and eliminate banks' exemption from investment adviser registration. Such limit, however, should not require banks to cease selling mutual

funds at their branch locations. We also would facilitate appropriate delegation by the functional regulator to the lead regulator for the entity, in the interest of simplicity and economy (e.g., the SEC could, at its discretion, delegate to bank regulators responsibility for overseeing a bank's investment advisory activities in accordance with SEC rules).

National Council on Financial Services

The nature of financial market changes in recent years has been the result not only of industry innovations and initiatives, but also the numerous rulings of state and federal regulators and the courts. This process has often led to competitive inequities, costly litigation, and random restructuring of financial services. Because of this there is a need to provide a means for the overall coordination of financial modernization.

We would establish a seven-member National Council on Financial Services, consisting of the following officials or their designees: the Secretary of the Treasury, who would serve as Chair of the Commission; the Chair of the Federal Reserve Board, who would serve as Vice Chair of the Commission; the Chair of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Chair of the Securities and Exchange Commission; and the Chair of the Commodity Futures Trading Commission.

The Council, modeled on a similar entity in S. 337 and H.R. 814, would be an inter-agency policy forum -- not a hands-on regulator or bureaucracy. And unlike the entity in those bills, the Council would not issue binding rules governing agencies' examination and supervision of financial institutions. The Council would not have a sizeable staff of its own.

The Council would be authorized to:

- determine what activities are financial;
- determine the circumstance under which consolidated capital requirements should apply to financial services holding companies whose subsidiary insured depository institutions account for less than half of those companies' total assets; and
- provide a forum for regulators to improve coordination on financial modernization issues.

We believe it is important that the Council take into account differences among financial services holding companies, such as the proportion of the companies' total assets in insured depository institutions, in weighing whether to impose consolidated capital standards. In short, there is no reason for a holding company with a relatively small presence in banking to

be held to the same consolidated capital requirement as a holding company primarily engaged in banking. Moreover, the insured depository in such a holding company would always be protected by the requirement that it be well-capitalized.

Expanded Powers

We believe that it would be logical and sound to permit well-capitalized and well-managed national banks to underwrite and deal directly in municipal revenue bonds. National banks have long had authority to underwrite and deal in general-obligation municipal bonds. This proposal would give well-capitalized national banks that do not have securities affiliates similar authority to underwrite and deal in municipal revenue bonds -- a type of security that has become increasingly important to local governments over the past decades. And we would support lifting the current restrictions on nonbank banks whose parent institutions become financial services holding companies.

Separation of Banking and Commerce

We do not support removing the current prohibitions against combining banking and commerce. Such combinations might pose additional, unforeseen and undue risks to the safety and soundness of the financial system, potentially exposing the

federal deposit insurance funds and taxpayers to substantial losses. Equally uncertain is the effect such combinations might have on the cost and availability of credit to numerous, diverse borrowers and on the concentration of economic resources. In particular, potential abuses might not only involve direct financial support of affiliated industrial companies by the insured depository institution but also transactions with companies that purchase from, or supply to, affiliated industrial companies.

Bank supervisors in the U.S. have not had sufficient experience with the types of risk that accompany banking and commerce. A regulatory means to detect and prevent abuses would be very difficult to implement and it would surely require substantial increases in the size of the examination forces. In other countries such as Germany, such linkages are tolerated. Recent reports from Germany, however, indicate that a reexamination of the close, traditional linkage of banking and commerce is underway in that country. Prudence suggests that we look much more closely before permitting affiliations of banking and commerce.

National Treatment

To reap the full benefits of financial modernization, it is crucial that any financial modernization legislation provide

national treatment in the U.S. for foreign financial institutions with respect to the benefits of affiliation. Failure to provide national treatment would send the wrong signal. It would discourage many foreign financial institutions from committing their capital and resources to our market, and it would undermine our continuing efforts to open foreign financial markets to U.S. financial services providers.

The Financial Services Competitiveness Act

I would now like to discuss our views on H.R. 18, put forth by Chairman Leach.

As a general matter, we agree with the direction taken by H.R. 18. The reform of Glass-Steagall provided for clearly advances the objectives of financial reform discussed earlier. It promotes efficiency and competition by removing outdated, unwarranted restraints on affiliations of investment banks and commercial banks. And it promotes competitive equity by providing for a two-way street. Common ownership of these entities will permit them to offer a broader range of financial services at greater convenience and potentially lower cost for end-users. This should enhance the profitability and stability of financial services providers.

We also view positively the fact that H.R. 18 renames the Bank Holding Company Act the Financial Services Holding Company Act, and amends the Act in a way that should expand the range of financial activities permitted financial services holding companies. H.R. 18 promotes financial system safety and soundness and protects consumers by emphasizing strong capital, firewalls, and consumer disclosures. It also advances functional regulation. We view H.R. 18 as decidedly meritorious.

There are, however, certain issues raised by the bill that we wish to comment on in greater detail. These issues involve bank structure, the scope of bank activities, prudential standards and safeguards (firewalls), and regulation.

<u>Bank Structure</u>

The reform of Glass-Steagall proposed in H.R. 18 is based exclusively on the holding company approach to expanding bank activities. Thus a banking organization could engage in the full range of securities activities only by forming a nonbank affiliate of the holding company.

We are not convinced that the law should be so restrictive. The primary goal of segmenting activities is protection of the safety and soundness of insured depository institutions. We believe that placing new securities activities in a subsidiary of

the bank does not harm that goal. In analyzing this issue we should not focus on form over substance. The legal nature of the entity, whether a nonbank affiliate of a holding company or a subsidiary of the bank, is not the issue, since both are separate legal entities from the bank. The issue is the integrity of the safeguards. Once we have reached a comfort level in that integrity, the safeguards function under either structure. Comptroller of the Currency Ludwig commented, from a regulatory perspective in his testimony before you yesterday, on the OCC's conviction that such an approach could be done with safety and efficiency. Since the safeguards work either in a subsidiary of the bank or a nonbank affiliate of a holding company, we should not take away management's flexibility to structure a financial services organization for optimum performance.

Scope of Bank Activities

For many of the same reasons we support Glass-Steagall reform, we believe there are grounds for permitting affiliations between banks and firms engaged in financial activities. In our view the most obvious of these affiliations is the one between banks and insurance companies. As discussed earlier, we believe that broader affiliations for banks can yield many benefits without jeopardizing bank safety and soundness. Among the benefits are greater convenience and potentially lower costs for consumers, product diversification and more stable earnings for

banks, and a generally more efficient and competitive financial system. Moreover, with certain insurance activities, banks do not assume the risk of underwriting, and banks' capital remains unimpaired. As with securities, and given the proper prudential standards and safeguards, it seems to us that affiliations between banks and insurance companies should be permitted. An explicit provision regarding such affiliations should be included in legislation.

H.R. 18 would grandfather unitary thrift holding companies, an approach that we believe would be more appropriate than requiring divestitures of thrifts. The thrift institutions at issue here generally are specialized housing lenders. They are not a primary source of loans to the wide array of commercial and industrial firms served by banks. If properly regulated, their affiliation with commercial entities does not raise serious concerns. Moreover, the Office of Thrift Supervision reports that experience to date has not revealed any safety and soundness problems with unitary thrift holding companies. On balance, we believe the unitary thrift holding company exemption represents sound policy and should not be changed, with the one proviso that commercial lending represent no more than 10 percent of such a thrift's assets.

A unique aspect of H.R. 18 is the provision for a "wholesale financial institution" as part of an "investment bank holding

company." The wholesale financial institution would be uninsured and generally restricted to only accepting deposits in excess of $100,000, although it would have access to the payments system and the Fed's discount window. The wholesale financial institution and its parent investment bank holding company would be regulated, but because the depository is uninsured it would not be subject to as many firewalls as an insured institution. While we generally support the idea of less-regulated wholesale banks and holding companies, we also think it is important to provide for appropriate supervision. The fact that the wholesale bank is uninsured does not mean that it is completely insulated from, and cannot transfer risk to, the federal safety net and the financial system.

Regulation

H.R. 18 provides for SEC registration and regulation of securities affiliates and banks that conduct certain securities activities. This advances the concept of "functional regulation" which would have the same entity regulate a given activity regardless of who conducted the activity. Some of the advantages of functional regulation include: greater consistency in the regulation of any given activity; the development of greater expertise and experience in a specialist agency; and a potentially more cost-effective regulatory structure.

While we agree with H.R. 18 that functional regulation is overall the best approach, we also recognize it has some shortcomings. For one thing, certain financial activities are not always that easy to differentiate one from another, and choosing the most appropriate regulator may be difficult. In addition, functional regulation may leave unresolved problems of potential regulatory gaps as well as overlapping regulation. For example, the securities subsidiary of an insurance company may be regulated by the SEC while the parent insurance company has no federal regulation whatsoever, resulting in a regulatory gap. On the other hand, a bank engaged in securities activities would be regulated by the SEC for securities activities and its federal bank regulator for banking activities and overall financial condition, resulting in regulatory overlap. Finally, if not properly structured, no single regulator may get a sufficiently clear picture of the financial condition of the whole entity to prevent potential safety and soundness problems.

These shortcomings should be addressed through additional safeguards, including: (1) maintaining the authority of insured depository institutions' primary federal regulators to verify compliance with restrictions on the institutions' transactions with affiliates; (2) requiring federal regulators of affiliated insured depository institutions to coordinate the institutions' examinations so as to prevent such abuses as shell games, as well as to minimize overlap; and (3) facilitating appropriate

delegation by the functional regulator to the lead regulator for the entity, in the interest of simplicity and economy.

Firewalls

The proposed legislation includes a number of explicit inter-affiliate transactions restrictions designed to insulate the bank from the securities affiliate. These restrictions serve to protect the safety and soundness of banks affiliated with securities firms and deny bank securities affiliates an unfair funding advantage because of their association with an insured deposit-taking entity. Also included are provisions intended to ensure that banks continue to make impartial lending decisions and guard against conflicts of interest. Finally, disclosure provisions are included to protect bank customers and securities investors from confusion and wrongful use of customer information.

As mentioned earlier, while we believe that appropriate firewalls can be very helpful, there also is a real danger that they can become excessive and rigid in nature, potentially needlessly negating the synergies to be realized from the permitted affiliations. As a case in point, we believe that it is appropriate and even beneficial to have some directors of the holding company and/or bank on the board of an affiliate. As a business matter, prohibiting such sharing of director

perspectives would be a mistake, because the affiliates may become too remote from the parent institution. To realize the benefits of integrated activities, management and the board of directors must be fully engaged in and responsible for all of the operations of the full entity.

In our view, the best approach would emphasize necessity and regulatory flexibility in the imposition of firewalls.

Conclusions

As we move forward, we need to keep in mind that as with all new opportunities we need to give attention to the potential risks. We know the risks involved with equities and insurance, but they are risks that have heretofore been only incidentally related to the banks -- at least in this country. Therefore the question we need to ask is: How will we manage the risks? Nothing is more important, in my judgment, than making sure we maintain the safety and soundness of our banks. I believe it can be done with proper safeguards and proper firewalls.

We believe the Financial Services Competitiveness Act of 1995 will serve as an important catalyst for addressing financial modernization. The bill provides a comprehensive framework within which the major issues can be examined. The bill is

generally consistent with what we believe are important objectives and guidelines for financial modernization.

As discussed, however, we do have a number of concerns about some aspects of the bill that we hope we can resolve as we work with Members of this Committee.

Likewise, we hope that our thoughts on issues and approaches will be of value to you and other participants in the process.

Finally, I want to take this opportunity to welcome the Committee's plans to hold hearings later this month on the Savings Association Insurance Fund. The Fund has less than $2 billion in reserves to insure over $700 billion in insured deposits, and we believe that a thoughtful public review of the Fund's prospects is very appropriate at this time, since it will begin protecting depositors in July when the RTC's responsibilities for resolving new failed institutions ends.

Again Mr. Chairman, we congratulate you, Mr. Baker, and the Members of the Committee for moving with dispatch to address the pressing needs of financial modernization. It is our view that an interactive, bipartisan effort can yield significant results in relatively short order. We look forward to working with you in the coming months to achieve our common goals.

Treasury Department Response
to Question from Representative Roukema

Question

How can a separate capitalization requirement that creates limited liability for losses of operating subsidiaries override the GAAP accounting requirements that are under the statute?

Answer

The answer is based on the difference between accounting losses and economic losses. The relevant policy issue is not how losses are reported for accounting purposes but how they impact the FDIC and taxpayers if the parent bank fails.

For GAAP accounting purposes, any company having a controlled subsidiary must consolidate the subsidiary's financial statements with its own. Losses in the subsidiary would be reflected in the parent's consolidated income statement, and capital reductions in the subsidiary would similarly be charged against the parent's consolidated balance sheet.

The same accounting treatment would apply to a holding company that directly owned a nonbank subsidiary. Since most public reporting is at the holding company level rather than the bank level, it should not make much difference whether the subsidiary is owned by the bank or by the holding company. In either case it would be the holding company's consolidated financial statements that the public sees.

Economic losses, on the other hand, are legal liabilities that may differ from financially reported losses under GAAP. When the FDIC steps in as receiver of a failed bank, balance sheet numbers become irrelevant. The cushion for the FDIC's interest is the bank's real capital -- that is, the difference between the market values of the bank's assets and liabilities. So long as the subsidiary liability cannot be charged against the parent bank -- that is, so long as the corporate "veil" is not pierced, it is irrelevant how the bank's consolidated financial statements previously reflected its interest in the subsidiary. And where there is a factual basis for piercing the veil, it is just as likely to exist whether the subsidiary is owned by the bank or directly by the parent holding company.

It is true that bank examiners apply GAAP accounting rules in assessing capital adequacy of the bank. But since risk to the FDIC is related to the real value of the bank's capital on a stand-alone basis, this supervisory treatment should be viewed as added protection to the FDIC.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

FINANCIAL MODERNIZATION: A PROPOSED APPROACH

March 1, 1995

I. Objectives and Guidelines

- Promote efficiency and competition -- and better service for users -- by eliminating needless restrictions.

- Ensure the safety and soundness of FDIC-insured depository institutions. Safeguard the federal deposit insurance funds and the financial system.

- Encourage market discipline, and avoid extending the federal safety net.

- Provide effective oversight of the affiliations and activities in question.

- Advance competitive equality.

  For example, when repealing section 20 of the Glass-Steagall Act (and thus permitting banks to affiliate with securities firms), provide a meaningful two-way street by which securities firms can affiliate with banks.

  Provide national treatment to foreign banks and foreign financial companies.

- Make U.S. financial institutions stronger at home so that they can compete better abroad.

II. New Affiliations Permitted

- Permit affiliations between FDIC-insured depository institutions and companies engaged in financial activities.

  Thus, for example, a bank could affiliate with a securities firm, an insurance company, or another company whose activities are

financial. A securities firm, insurance company, or other financial company could affiliate with a bank.

- Repeal section 20 of the Glass-Steagall Act and the insurance restrictions in the Bank Holding Company Act.

  Section 20 generally prohibits a bank that is a member of the Federal Reserve System from being affiliated with a company principally engaged in underwriting or dealing in securities that a national bank cannot underwrite or deal in directly. The Bank Holding Company Act includes restrictions on bank holding companies' insurance activities. Repealing these restrictions would clear the way for insurance companies and banks to affiliate.

  - Allow the affiliated companies to be subsidiaries of either the insured depository institution or the institution's parent company.

    The choice of corporate structure would be a private business decision, not a regulatory dictate.

- Maintain the prohibition against affiliations between insured banks and companies engaged in *non*financial activities.

II. Qualifying for These New Affiliations

- Permit insured depository institutions to become affiliated with firms that underwrite securities or insurance that a national bank cannot underwrite directly if regulators find that:

  - the institutions are well-capitalized and well-managed (and any holding company subject to capital standards meets those standards);

  - the institutions and their affiliates have internal controls adequate to manage financial and operational risk; and

  - the affiliation would be unlikely to impair the institutions' safety and soundness.

- Permit such affiliations to be established only with capital over and above what the insured depository institution or holding company needs to meet its own capital standards.

- Prohibit continued affiliation between an insured depository institution and an affiliate engaged in securities or insurance underwriting not permissible for a national bank, if the institution (or any of its insured depository affiliates) remains undercapitalized for more than six months (or with regulatory approval, for an additional 18 months).

  The above safeguards, and those following, have important parallels with H.R. 18.

IV. Additional Safeguards

- Take the following steps to help assure that insured depository institutions' affiliates do not become a source of weakness to the institutions:

  - Maintain the Federal Reserve Board's authority to prescribe consolidated capital standards for bank holding companies whose subsidiary insured depository institutions constitute their principal business (by comprising at least half of the bank holding companies' total assets).

    Consolidated capital standards can serve as a measure of the health of the overall organization -- and thus reduce the chances that affiliates' weakness would pose unacceptable risks to insured depository institutions. But applying consolidated capital standards to highly diversified financial services organizations may not be appropriate or meaningful (e.g., in view of differences in prevailing capital levels from one industry to another). Accordingly, under this proposal, such standards would remain discretionary, and a new interagency coordinating council would determine under which circumstances such standards would apply to holding companies that have less than half of their assets in insured depository institutions. Note that insured depository

institutions now typically account for most of the assets of bank holding companies.

The Federal Reserve Board would continue to administer the Bank Holding Company Act for all bank holding companies.

- Maintain the authority of insured depository institutions' primary federal regulators to verify and enforce compliance with restrictions on the institutions' transactions with affiliates.

- Require federal regulators to coordinate institutions' examinations so as to prevent such abuses as shell games, as well as to minimize overlap.

  This would complement existing law requiring regulators to coördinate examinations so as to reduce regulatory burden.

- Apply appropriate firewall restrictions. Employ a combination of rules and directives to regulators.

  - *Rules:* E.g., an insured depository institution may not generally extend credit to its securities affiliate, or issue guarantees for the purpose of enhancing the marketability of securities being underwritten by the securities affiliate.

  - *Directives to regulators:* Deal with the following practices not by general prohibitions but by requiring regulators to prescribe appropriate regulations designed to prevent the practices from causing problems: the institution and securities affiliate's having officers or directors in common; and extensions of credit by an insured depository institution to pay principal, interest, or dividends on securities underwritten by a securities affiliate.

- Require appropriate disclosure so that customers do not confuse uninsured products with insured deposits. Protect confidential customer information.

- Apply the following additional safeguards to insured depository institutions controlled by companies that are *not* subject to consolidated capital standards:

  - require the insured depository institutions to be well-capitalized;

  - require any institution that ceases to be well-capitalized to submit an acceptable capital restoration plan within 60 days, and permit regulators to accept the plan only if each company that controls the institution guarantees the institution's compliance with the plan; and

  - if the institution fails to comply with the above requirement, require orderly divestiture of the institution within one year, and authorize regulators to require earlier divestiture if necessary to keep the institution safe and sound.

    The requirement of a capital restoration plan and parent company guarantee parallels the current "prompt corrective action" statute -- but uses well-capitalized (rather than adequately capitalized) as the standard.

V. Two-Way Street

- As described above, permit companies engaged in financial activities to affiliate with insured depository institutions, just as insured depository institutions are permitted to affiliate with such companies.

- Allow affiliates of insured depository institutions to hold a diversified portfolio of investments in nonfinancial firms made in the course of the affiliates' merchant banking or venture capital activities. Limit such investments in the aggregate to an appropriate level such as 5 percent of the total assets of the insured depository institution and its affiliates.

- Simplify the Bank Holding Company Act (e.g., to streamline the current application process, and avoid applying to diversified financial services firms detailed rules for the conduct of activities). Rename the Act the Financial Services Holding Company Act. Likewise redesignate bank holding companies as "financial services holding companies."

VI. Regulatory Coordination

A. Functional regulation

- Limit banks' current exemption from SEC broker/dealer registration. Eliminate banks' exemption from investment adviser registration.

- Facilitate appropriate delegation by the functional regulator to the lead regulator for the entity, in the interest of simplicity and economy (e.g., the SEC could, at its discretion, delegate to bank regulators responsibility for overseeing a bank's investment advisory activities in accordance with SEC rules).

B. National Council on Financial Services

- Establish a seven-member National Council on Financial Services, consisting of the following officials or their designees: the Secretary of the Treasury, who would serve as Chair of the Council; the Chair of the Federal Reserve Board, who would serve as Vice Chair of the Council; the Chair of the Federal Deposit Insurance Corporation; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Chair of the Securities and Exchange Commission; and the Chair of the Commodity Futures Trading Commission.

  The Council, modeled on a similar entity in S. 337 and H.R. 814, is an inter-agency policy forum -- not a hands-on regulator. And unlike the entity in those bills, the Council would not issue binding rules governing agencies' examination and supervision of financial institutions. The Council would not have a sizeable staff of its own.

- Authorize the Council to:

  - determine what activities are financial;

  - determine the circumstances under which consolidated capital requirements should apply to financial services holding companies whose subsidiary insured depository institutions account for less than half of those companies' total assets; and

- provide a forum for regulators to improve coordination on financial modernization issues.

In weighing whether consolidated capital standards should apply, the Council should take account of differences among financial services holding companies, such as the proportion of the companies' total assets in insured depository institutions.

VII. Municipal Securities in Bank

- Permit well-capitalized, well-managed national banks to underwrite and deal directly in municipal revenue bonds.

National banks have long had authority to underwrite and deal directly in general-obligation municipal bonds. The proposal would give well-capitalized, well-managed national banks similar authority to underwrite and deal in municipal revenue bonds -- a type of security that has become increasingly important to local governments over the past several decades.

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H.R. 1062, THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995, GLASS-STEAGALL REFORM, AND RELATED ISSUES (REVISED H.R. 18)—PART 2

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MARCH 7, 15, 1995

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APPENDIX

H.R. 1062, THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995, GLASS-STEAGALL REFORM, AND RELATED ISSUES (REVISED H.R. 18)

TUESDAY, MARCH 7, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach [chairman of the committee] presiding.

Present: Chairman Leach, Representatives Roukema, Bereuter, Baker, Lazio, Royce, Barr, Chrysler, Heineman, Kelly, LaFalce, Vento, Roybal-Allard, Velazquez, Wynn, and Bentsen.

Chairman LEACH. The committee will come to order to continue our hearings on reform of the Glass-Steagall Act. We have two distinguished panels of witnesses. We've given a precise time for the second panel, so there will not be a circumstance where people are waiting for the first panel to finish.

Our first panel is composed of Mr. Richard Roberts, who is executive vice president and treasurer of Wachovia Corporation. Then we have Mr. Richard Mount, who is president of the Saratoga National Bank; Mr. Weller Meyer, who is president and CEO of Acacia Federal Savings Bank; Mr. Allen Croessmann, of the Bank of Boston; and Mr. Robert Freeman, yes. I apologize. I went over your name.

We begin with Mr. Roberts.

STATEMENT OF RICHARD B. ROBERTS, EXECUTIVE VICE PRESIDENT AND TREASURER, WACHOVIA CORPORATION

Mr. ROBERTS. Thank you, Mr. Chairman, for inviting me to participate in this important series of hearings on Glass-Steagall reform. I commend you and your leadership for introducing H.R. 1062 early in this Congress, giving us an opportunity to finally enact banking reform legislation.

Basically, my message this morning is very simple; the legal and regulatory structure of our financial system must be modernized. Over the past decade, our financial markets have been transformed by a tidal wave of technological advances. In the next decade, the pace of change is likely to accelerate.

When markets change and the regulatory structure does not, distortions develop. The regulatory structure itself, not the competitive market, determines which firms can supply which products. This is not a healthy situation for financial service providers, or for

the customers they serve. We must work together to create a financial framework that accomplishes the following goals: First, it must allow banks and banking organizations to offer more products and services and promote free and fair competition among different sizes and types of firms; second, it must be flexible enough to adjust to changing consumer demands, market conditions and technology; third, it must provide adequate protections to insure safety and soundness without adding unnecessary costs; and fourth, it must provide consistent regulation by function, treating all financial service providers equally, regardless of organizational structure.

The ABA on behalf of banks across the country has long supported Glass-Steagall reform. But this is not just a banking issue; reform of Glass-Steagall will bring substantial economic benefits to a very wide range of bank customers.

I particularly commend allowing banks to underwrite municipal revenue bonds, as H.R. 1062 proposes. It is a very good example of the substantial economic benefits that will occur as a result of banking reform. Increased competition in municipal markets will reduce cost and offer small municipalities an important financing option. Local banks already provide a wide range of financial services to their communities, including underwriting general obligation bonds. Bankers have the knowledge and expertise to underwrite revenue bonds.

Allowing banking organizations to underwrite corporate debt and equities will provide similar benefits to businesses. More underwriters mean more competition. More competition means more choices and lower prices.

Small- and mid-sized businesses, especially those located outside of metropolitan areas, will also benefit. These businesses probably do not have a relationship with Wall Street, but they do have a relationship with their local bank. Banking institutions can give small- and mid-sized businesses access to capital markets, increase their financing options and lower their cost of funds.

In a nutshell, Mr. Chairman, there is no doubt reform of Glass-Steagall will improve the efficiency of financial markets. There is also no doubt that reform of Glass-Steagall can be accomplished without endangering the safety and soundness of our financial system, or the deposit insurance fund.

Banks have been involved in security activities for many years, and there's no evidence that these activities have raised risk profiles. In fact, the opposite is more likely. Diversification of activities typically lowers an institution's risk.

Extensive regulations to protect against potential problems already exist. Since the passage of Glass-Steagall, a highly sophisticated regulatory regime has been developed for governing the activities of banks, bank holding companies and security firms, including Section 23A and 23B of the Federal Reserve Act, Section 106(b) of the Bank Holding Company Act amendments of 1970 and extensive prudential regulations imposed on both banks and security firms.

It is time to take constructive action to bring our financial system up to date. What we think of as traditional banking is steadily losing market share. Banking organization stocks continue to sell

at low relative price-to-earning ratios as compared to the S&P 500, despite the industry's record earnings.

The fact is, the market perceives banking as an industry tied in knots by its legal and regulatory structure, an industry that is unable to be full and effective competitors. In the long run, an industry unable to compete because of out-of-date laws cannot be strong or sound.

Let me add one final thought. Imposing excessive firewalls on banking organizations can undermine the very purpose of modernization. Many companies, including some of the largest in the country, already offer virtually all financial services, including the traditional banking services, basically without the firewalls. These are the companies that I compete with day in and day out.

I commend you, Mr. Chairman, for your leadership on this issue. I look forward to working with you and the members of the committee to design a financial framework based on the realities of today's marketplace, and will be glad to answer any questions you may have.

Thank you.

[The prepared statement of Mr. Richard Roberts can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Roberts. You read an abbreviation of your full testimony, which will be put in the record. I ask unanimous consent that all full statements be put in the record.

I'd now like to turn to Mr. Mount, who is president of the Saratoga National Bank.

Mr. Mount.

STATEMENT OF RICHARD L. MOUNT, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, AND PRESIDENT, SARATOGA NATIONAL BANK

Mr. MOUNT. Good morning, Mr. Chairman. My name is Richard Mount. I am president and CEO of Saratoga National Bank, an $85 million community bank, located in Saratoga, California. I'm also president of the Independent Bankers Association of America.

The IBAA is the only national trade association that exclusively represents the interests of the Nation's community banks. We appreciate this opportunity to testify on the issues of the Glass-Steagall Act, and Bank Holding Company Act Reform proposals. Both of these acts have been cornerstones in maintaining the safety and soundness of our banking system, prohibiting undue financial concentration and protecting the integrity of the deposit insurance fund.

These legislative foundations helped create a remarkably diverse financial services industry, which in turn supports the strongest, small business structure in the world. When you legislate changes, you must be convinced that they are for the betterment of all America and all Americans, and not just for the betterment of Wall Street, and for those few banks that wish to compete on a global basis.

Our main caution with regard to Glass-Steagall Act reform would be, please do it right and know what we are doing. Otherwise, future Congresses will have to deal with the mess we created. The Leach bill comes the closest to meeting this test.

Just a little background about Glass-Steagall. The Glass-Steagall Act was enacted as part of the Banking Act of 1933. It is part of the protections that we put into place to prevent a recurrence of the systemic collapse of the banking system.

As my written testimony makes clear, the purpose of Glass-Steagall was to limit the securities activities of banks because of the various hazards connected with mixing investment and commercial banking.

The Bank Holding Company Act prohibits the mixing of banking and commerce. The restrictions were enacted because Congress felt that otherwise there would be consolidation in the industry that would lead to monopolization and huge banking and industrial complexes which would be created if bars were not put into place.

These issues have not changed over the years. I would like at this time to add to the record an article by Alan Sloane that appeared in today's *Washington Post* that underscores this point: "There is still the potential for conflicts of interest when banking and nonbanking firms affiliate. Massive industry consolidation will lead to unmanageable systemic risk."

Former FDIC Chairman William Seidman testified before the Senate Banking Committee that nonbank bank loopholes which breach the wall between banking and commerce are highly inequitable and detrimental. Allowed to grow, nonbank banks can weaken the real banks by competing in an unfair contest within the marketplace. Breaching the banking and commerce wall, also undermines bank supervision. This was made clear in Federal Reserve Chairman Alan Greenspan's testimony before the committee last week.

There are three proposals on the table at the present time. In summary, they would amend the Glass-Steagall Act and the Bank Holding Company Act in the following ways: The broadest and possibly the most dangerous proposal is the one put forth by Congressman Baker, and we strongly oppose this approach.

This proposed legal structure would permit a holding company to own Ford Motors, Prudential Insurance, Merrill Lynch and Chase Manhattan Bank. Breaching the banking and commerce law in this manner, will allow for the possibility of a systemic risk that could prove to be fatal to our financial system.

Insurance underwriting brings with it some very large risks. Insurance companies are direct investors and developers of real estate, and they invest in many other types of assets, including derivatives. Yet, insurance companies are not federally regulated.

This committee should be most careful indeed about putting haphazardly regulated financial entities together in a common structure, particularly in light of the concerns Chairman Greenspan has raised about the firewalls.

Additionally, functional regulation is no substitute for having a regulator supervise the entire entity. Such supervision gives one regulator an overall picture of the financial condition of the entity, and allows for early action with regard to the entire holding company if problems begin to arise.

The Administration's proposal would allow the affiliation of commercial banks, investment banks and any other financial company, including insurance underwriters. These entities could be

affiliated either in a holding company structure or as a parent-subarrangement with the bank as the parent.

This proposal causes us great concern and we strongly oppose it. First it allows an insurance underwriter to be affiliated with a bank, an issue which I have already discussed. Second, the ability of the bank to hold securities and insurance affiliates as a subsidiary is also fraught with danger. The closer together these companies are, the more they will be identified by the public as a common entity. Third, the cross-marketing and joint-marketing of services raises the likely prospect of customers' confusion over whether a product is insured by the FDIC or not insured.

Finally, the integration of services gives large, integrated companies an unfair competitive advantage over independent banks. The simple fact is that the small banks do not have the resources to be players in this market, and thus, they are effectively frozen out of the integrated market.

Chairman Leach's bill would allow the affiliation of commercial banking and investment banking under a bank holding company that is regulated by the Federal Reserve Board. The bill would also amend the Bank Holding Company Act and allow bank holding companies to own companies that are financial in nature, except for insurance underwriters.

The bill contains firewalls substantially in excess of those in Congressman Baker's bill. However, in our view, the question is still open as to whether the protections are sufficient.

The IBAA is currently studying this issue to determine the most probable manner that banking and Main Street America will be affected by H.R. 1062. We recognize the financial services industry has changed significantly over the last 2 decades, both nationally and internationally. We also recognize that large banking companies compete in different markets than community banks, therefore, they may need to exercise powers that they do not now possess in order to compete in those markets.

However, granting large banks powers cannot be at the expense of the community banks and the communities and small businesses that they serve so well.

These issues need to be fully examined in the debate over the reform of Glass-Steagall. Although H.R. 1062 certainly goes down the road to protecting these important interests, more evidence is necessary to determine if in fact it gets there.

In 1987, the Competitive Equality Banking Act closed the nonbank bank loophole to the Bank Holding Company Act. The loophole exempted banks that did not make commercial loans from the requirements of the Bank Holding Company Act, thus allowing the mixing of banking and commerce, and imposed restrictions on the grandfathered companies, including the limiting of their asset growth.

The reason for limiting nonbank banks in 1987 has not changed. Under current law, unitary thrift holding companies are not prohibited from affiliating with commercial firms. This has allowed thrifts to affiliate with industrial and other types of companies in violation of prudent, safe and sound principles. The risks of merging banking and commerce are just as applicable today as they were years ago.

In conclusion, the Glass-Steagall and the Bank Holding Company Acts have provided significant protections to our banking system and to competitive equality in this country. This has given the United States an economic and financial system which is the envy of the world. Efforts to make major changes in the system should be undertaken only after long and careful deliberation.

Additionally, changes should be made on an incremental basis. No one can predict with certainty what the outcome of the proposed changes will be. If we take too great a leap, we may find we have fallen off the precipice.

Change can destroy as well as build. We are still witnessing the ongoing destruction of the savings and loan industry—a process that was hastened by public policy decisions.

Mr. Chairman, I wish to thank you and your committee for the opportunity to present the views of the IBAA on this most important subject.

[The prepared statement of Mr. Richard Mount can be found in the appendix.]

Chairman LEACH. I thank you, Mr. Mount.

We'll now turn to Mr. Robert Freeman, who is chairman and CEO of Signet Banking Corporation.

Mr. Freeman.

STATEMENT OF ROBERT M. FREEMAN, PRESIDENT, THE BANKERS ROUNDTABLE, AND CHAIRMAN AND CEO, SIGNET BANKING CORP.

Mr. FREEMAN. Thank you. Mr. Chairman, members of the committee, I am Robert M. Freeman, chairman and chief executive officer of Signet Banking Corporation in Richmond, Virginia. It's a $10 billion diversified banking firm. I'm here today to represent The Bankers Roundtable and to address the important issue of modernizing the United States banking law.

I'm privileged to serve this year as president of the Roundtable, the membership of which is open to the largest 125 banks in the country, representing organizations from about $2 billion to about $200 billion in size. It also represents about 70 percent of the banking assets in the United States.

The Roundtable appreciates your efforts, Mr. Chairman, to focus on legislation that would modernize the nation's banking law by the early introduction of the Financial Services Competitive Act of 1995, H.R. 18 and H.R. 1062. We appreciate your long-standing commitment and that of the committee to making needed reforms, and we're particularly grateful for the advances made last year in interstate branching and regulatory burden relief.

The Roundtable's view of financial services reform is summarized in our products and services policy statement attached to my statement. In our view, significant changes are needed to keep our financial system healthy, stable and capable of meeting user needs well into the future.

The Bankers Roundtable believes that the public will be best served by laws that allow the banking system to meet the needs of consumers, businesses and governments efficiently, conveniently and economically. Banks continue to play a fundamental role in our

Nation's economy and the franchise should be preserved and strengthened.

As we work to make our banking and financial system stronger, the Roundtable believes that a number of principles are key to legislation. Foremost is safety and soundness; second, improving the delivery of financial products and services to users; third, enhancing competition in the financial services marketplace; fourth, creating a clear legal framework on which providers and users of financial products and services may rely; five, enhancing flexibility in management decisionmaking; six, encouraging product innovation and flexible corporate structures to provide financial products and services that meet customer needs; seventh, developing an incentive based regulatory system that supports prudent operations by institutions and permits the best equipped firms to meet user needs; and eighth, continuing the integration into the banking system of technological developments that improve the ability to create and deliver financial, payment-related and information services to customers.

We're also cognizant that achieving needed reforms with these criteria in mind may take time and require incremental but positive solutions.

Consistent with our recommendations, The Bankers Roundtable supports H.R. 1062 as a strong statement of needed reform. The Roundtable supports the efforts you're undertaking and is committed to work with you in developing the concept to its fullest.

The Bankers Roundtable has an important caveat, however, that needs to be emphasized here. We cannot support any legislation which takes away from the products and service authority that banks already have. Banks should not be asked to retreat from the position they occupy today. Federal policy should enhance the fundamental bank franchise, such as by authorizing revenue bond underwriting as envisioned in H.R. 1062.

The Roundtable cannot support legislation that would undermine the activities in which banks engage today or legislation that prevents banks from meeting user needs in the financial marketplace of the future. Extraneous amendments limiting bank products and services must be rejected.

One of the most important influences on the ability to deliver financial products and services today is new technological development. New technology has permitted traditional lines of businesses such as mortgage lending to be accomplished more rapidly and conveniently; and also permitted new lines of business such as credit, debit and "smart" cards to provide significant benefits to consumers and governments.

Technology is altering the products. It's altering their delivery and those seeking to provide them. Soon we may be just as likely to meet our customers across an electronic network as in a bank lobby or across a boardroom table. As a result, banks are seeking to enhance their capabilities for delivering financial payment and related information services to users in new and innovative ways.

We, for example, at Signet have installed a computer based system to provide students with information about loans and grants that can be accessed through the Internet system. I think that's only beginning, not just for us, but for many, many others.

At the same time, nonbanking companies, including telecommunication, data processing and software firms, also are seeking to establish and expand their networks for delivering financial payment and related information services.

We urge special attention be paid to the impact that proposed legislation deregulating the Nation's telecommunications systems would have on the ability of banks to remain competitive. At the same time, I think Congress should assure that banks may continue to take advantage of new technologies in offering financial payment and information related services directly to customers, or by affiliating with firms that are engaged in those lines of business.

As noted earlier, H.R. 1062 is a significant step forward in modernizing the banking and financial system. Based on our initial review, I want to highlight items of significance to the Roundtable: Revenue Bonds. The legislation provides a step forward by adding revenue bond underwriting to bank product lines, though with a limitation based on geography.

Banks have traditionally underwritten general obligation securities of State and local government. The ability to underwrite revenue bonds is desirable, it enhances the banking franchise and fits with long-standing banking experience and services for their communities.

Structures for affiliation. The Roundtable urges that various structures for affiliation be available. The Roundtable considers holding companies to be a useful model. We also believe that bank operating subsidiaries, properly structured, may offer safe vehicles for providing services.

Corporate managers, based on capital and management strength should be able to adopt structures that meet user needs and demands. Regulators currently have ample authority to manage these structures.

Regulation of new products and streamlined procedures. Regulation should turn more to supervision and away from micromanagement. Institutions with strong capital positions and able management should see less regulation and greater freedom to innovate products and methods for their delivery.

H.R. 1062 contains several important provisions moving in that direction of incentive-based regulation. Two in particular, which we've long advocated, move in that direction. The first is, the bill would revise Section 4(c)(8) of the Bank Holding Company Act, which governs Federal Reserve Board consideration of nonbanking financial activities.

This bill would replace the traditionally "closely related" to banking test with a new financial-in-nature rule that would permit more flexible action by the Board to approve products and services as the financial marketplace evolves.

Second, the legislation would modify the current application process for nonbanking activities by providing a notice procedure for most activities and streamlining the process to permit expedited action. H.R. 1062 goes a long way toward placing banking organizations on a more equal footing with nonbanking competitors. The benefit of these changes really can't be overstated.

Cross marketing. A key benefit of affiliation should be consumer benefits. This depends on the ability to cross market and package

products and services. The value to users is to find products packaged the way they desire and available when and where they desire, while institutions maintain their safety and soundness and without any competitive practices.

In the current overlay of antitrust and banking laws, tying and disclosure rules provide consumer protections while permitting packaging of products to suit user needs. We are pleased that H.R. 1062 supports cross marketing with safeguards.

The Roundtable believes that the committee should modernize the law with the knowledge that a full panoply of safeguards is already in place. These safeguards protect the deposit insurance corporation, the deposit insurance system and the consumer. Any new, proposed restraints must meet the test of adding to safety and soundness and not duplicating current rules.

Safeguards should not serve only to dampen competition—and I've attached a memorandum to my statement that highlights the many safety and soundness protections for banks, taxpayers and deposit insurance that already exist. The Roundtable will be continuing to analyze H.R. 1062 and would appreciate the opportunity to communicate with the committee regarding this safeguard issue.

In conclusion, The Bankers Roundtable supports the efforts underway in this committee to change and modernize U.S. banking laws. You have initiated a process that ultimately will benefit the entire financial services system, and most importantly, the users of products and services. We look forward to assisting the committee in developing a solid plan for action that works in practice, is beneficial to the public and is achievable.

Thank you for the opportunity to testify, Mr. Chairman.

[The prepared statement of Mr. Robert Freeman can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Freeman. Our next speaker will be Mr. Weller Meyer, president and CEO of Acacia Federal Savings Bank.

Mr. Meyer.

STATEMENT OF WELLER MEYER, PRESIDENT AND CEO, ACACIA FEDERAL SAVINGS BANK, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. MEYER. Mr. Chairman and members of the committee, my name is Weller Meyer. I am president and CEO of Acacia Federal Savings Bank, which is located in Falls Church, Virginia.

Acacia Federal has approximately $400 million in assets and employs 48 people. Acacia Federal's parent company, Acacia Mutual Life Insurance, was chartered by a special act of Congress in 1869. Through the past 125 years, Acacia Mutual has enjoyed a well-earned reputation for financial strength and stability, prudent investment practices and leadership in the insurance industry.

Today I am representing America's Community Bankers, the national trade association for 2,000 savings and community financial institutions and related business firms. ACB strongly supports financial modernization efforts. We believe that each firm should be able to decide for itself, within the bounds of safety and soundness, the business strategy and corporate structure that will best allow it to compete.

This is why we vigorously oppose the attempt in H.R. 1062 to sharply limit the long-standing, unitary holding company option now available to savings institutions. This is dramatically opposed to the overall thrust of the bill, which is to add competitive opportunities.

We urge this committee to completely remove the limitation on unitary holding companies. Earlier this year, ACB formed the Defend Unitary Activities Coalition to fight the repeal of unitary holding company option in H.R. 18. This is why we oppose the repeal.

One, it would have seriously disrupted existing consumer and business relationships and caused serious economic losses; two, there's no public policy justification for repeal because existing law fully protects consumers and the FDIC; and three, the looming BIF/SAIF premium disparity means that SAIF-insured institutions may soon be paying much higher deposit insurance premiums than other institutions. Repeal would deny savings institutions access to an important source of new capital and earnings.

The grandfather proposal in H.R. 1062 is an unacceptable alternative because; one, two-thirds of the industry have not formed unitary holding companies and would lose an important business option and part of their franchise value; two, even grandfathered institutions would be hurt because an institution would lose its grandfathered status if it were sold to another firm; and three, the limited grandfather clause implies there's something wrong with the activities we are pursuing. Nothing could be further from the facts.

Our coalition includes institutions of all sizes from communities throughout the country. Major institutions are represented along with smaller companies located in states such as Iowa, New Jersey, Minnesota and Pennsylvania. Very concerned members are located in Hattiesburg, Mississippi, and Travelers Rest, South Carolina. The Coalition's letters to Congress are attached to my testimony.

Savings institutions have affiliated with nonfinancial firms for decades. Our limited commercial lending powers provide ample justification for this approach. Congress has maintained the separation of banking and commerce, but has not limited to combination of savings institutions and diverse firms.

Last week's testimony by acting OTS Director, Jonathan Fiechter before this committee provided an excellent account of the legislative history. Unitary holding companies provide consumers convenient and competitive service and can offer one-stop-shopping that is particularly valuable to increasingly busy customers.

Acacia Federal's banking products and services are easily available to the customers of our affiliates. By the same token, Acacia Federal customers can also obtain services from the holding company. The grandfather provision in H.R. 1062 would deny these benefits to additional consumers throughout the country.

The OTS closely regulates and supervises the relationship between Acacia Federal and its affiliates. The OTS reports that no systemic problems have resulted from the combination of savings institutions and diversified firms. In fact, diversified companies have infused billions of dollars of capital into savings institutions and continue to do so.

In our case, our parent company infused an initial $3 million of the capital and has continued to infuse capital to enable us to grow, adding a total of over $15 million. This support helps us maintain our strong commitment to the citizens of Northern Virginia.

Limiting the unitary holding company option would put substantial economic pressure on SAIF-insured members of the industry, at the same time it is facing a dangerous premium disparity. I know that the BIF/SAIF issue is not the subject of today's hearings and we look forward to presenting detailed testimony later this month.

However, now is not the time to undermine our industry's ability to attract new capital by limiting its competitive options. Sharply limiting the unitary option, as H.R. 1062 proposes, flies in the face of the current effort to modernize the financial system.

Chairman Greenspan told this committee last week that he has no philosophical problem with the combination of banking and commerce. He felt that it would be better to gain experience before taking the next step. Congress should maintain the unitary option for all savings institutions and allow the regulators to continue to gain relevant experience. Even the Administration, which would maintain the separation of banking and commerce, is against changes in the unitary holding company law.

Representative Baker's bill, H.R. 814, leaves the unitary savings and loan holding company option in place, a result much more in keeping with the general tenor of H.R. 1062.

Grandfathering hurts any savings institution that has not formed a unitary holding company. As our industry evolves, even smaller institutions will have to diversify to remain competitive. The unitary holding company will help savings institutions maintain and increase their ability to serve their communities. Even grandfathered institutions would be badly damaged since the bill handcuffs savings institutions to their holding companies.

Grandfather status lasts only so long as the original owner maintains control. Companies often divest subsidiaries in reaction to changes in corporate strategy and consumer demand. H.R. 1062 would make this much, much harder because another diversified company could not buy a savings association.

America's Community Bankers and the Defend Unitary Activities Coalition strongly urge this committee to completely eliminate the unitary holding company provision in H.R. 1062. Unitary holding companies have substantially strengthened our industry. They should be a beacon for the committee, not turned into financial pariahs.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Weller Meyer can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Meyer. Let me turn to Mr. Croessmann, who represents the Bank of Boston.

Mr. Croessmann.

STATEMENT OF ALLEN CROESSMANN, BANK OF BOSTON, ON BEHALF OF CONSUMER BANKERS ASSOCIATION

Mr. CROESSMANN. Mr. Chairman and members of the committee, my name is Allen Croessmann. I am the managing director of consumer investment services for Bank of Boston.

I also serve on the investments committee of the Consumer Bankers Association, the CBA. The CBA membership includes regional, super-regional and money center banks, a majority of which offer investment products to their customers, and my statement today concerns the delivery of those products.

I appreciate the opportunity to appear before the committee on behalf of the CBA to testify on the need of legislation to reform the regulatory framework governing the role of banks in the financial services industry.

Mr. Chairman, the CBA commends you for your leadership. Your bill H.R. 1062, the Financial Services Competitiveness Act of 1995, is an important step toward removing some of the regulations that encumber banks as financial services providers.

The CBA welcomes your initiative, and particularly appreciates the provision that would broaden the standard for permissible activities.

Reforming Glass-Steagall is essential today, as advances in technology permit new competitors to offer financial services. Microsoft, with its pending purchase of the company that sells the personal finance software Quicken, is an example of the type of competitor that will offer innovative alternatives to traditional banking.

The CBA believes that the focus of financial services regulation should not be on restricting competition, but on promoting it. The regulatory aim should be to ensure that financial services are widely available in the most convenient, flexible, efficient form consistent with safe and sound practices and due regard for protecting customers.

As the primary financial institution for a wide customer base, banks play an important role in educating customers on the advantages and disadvantages of all products available to meet their financial needs.

A major part of the marketing efforts of banks today consists of informational programs and materials designed to educate customers on the various features of these products.

Customers have new expectations for efficiency, flexibility and quality of service in today's market. Technological advances have improved the quality of life for consumers in many ways, and bank customers are demanding that their banks provide the same kind of time-saving products and services that modern technology has made possible in other areas.

Computerized communications and data processing systems are making it possible for banks to provide highly efficient integrated services in what we call a seamless fashion, and this is good for consumers because they benefit in many ways. The number of forms that the customer must fill out may be reduced because different parts of the Bank of Boston Corporation, for example, could have on-line access to computerized information about the customer. The amount of time the customer must spend waiting for service can be minimized. The customer can receive more efficient

individualized attention by the bank service representatives, who will know the extent of the customer's relationship with the various parts of the corporation.

The customers could be offered services that better correspond to their needs. Customers' needs could be anticipated and evaluated in a timely manner so that, for example, they could receive advice on making financial decisions when a certificate of deposit comes due.

Cross-marketing of products and services among the various parts of a banking organization obviously is a critical element to making seamless delivery possible. We are looking closely at the firewalls that would be imposed under H.R. 1062, particularly the provision regarding disclosure of confidential customer information.

We would like to work with the committee to make sure that this provision, while respecting customers' privacy, does not create operational problems that would unnecessarily hinder the ability of banks to integrate their services for the convenience of customers.

Let me turn to functional regulation. The CBA believes that the essence of functional regulation is to promote competition by promoting regulatory parity. We support a concept of functional regulation that would enhance, not impair, the ability of banks to serve their retail customers with maximum efficiency and convenience.

CBA believes that Congress should establish general parameters and principles to guide the financial services industry and should allow the appropriate regulators to implement more specific details.

The different financial regulatory reform proposals that have emerged this year raise important questions concerning the ultimate structure of our banking and financial services system. The CBA does not purport to have all the answers to these questions; however, we do believe that flexibility is essential. Each bank should be allowed to determine which structure is best suited to its ability to deliver financial services to its customers in the most efficient, convenient and competitive manner.

For some banks, this might mean selling securities and insurance products directly in the bank; for others, it might mean using a separate subsidiary of the bank to provide such services; and for still other banks, it might mean conducting these activities in a bank holding company affiliate.

Mr. Chairman and members of the committee, the CBA appreciates this opportunity to present our views on the need for financial services reform, and I would be happy to answer any questions and to provide additional information.

Thank you.

[The prepared statement of Mr. Allen Croessmann can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Croessmann.

We appreciate the whole panel's testimony, even Mr. Meyer, who critiqued my bill so thoroughly.

Let me just stress, Mr. Meyer, you know we have had two renditions of a particular approach. The first would have required divestiture so that we would develop a very pristine playing field. The second approach does call for grandfathering. As a minor correction in your testimony, the legislation does allow for a selling of

grandfathered rights if the holding company is sold, but disallows it if simply the thrift is sold.

But I would hope you would recognize that we have come a long way to protect the existing institutions, although not as far as you would like us to go.

In this regard, Mr. Mount, this committee is a refereeing committee between interest groups and there can be differences of judgment. For example, let me ask the independent bankers: What would your perspective be on the unitary thrift? Do you think this is an institutional framework that should continue, or how would independent banks——

Mr. MOUNT. No, I don't think it should continue. I think it's an unfair competitive advantage, and, no, it should not continue. They should be on the same level as the rest of the financial institutions.

Chairman LEACH. Fine. I appreciate that.

I'm not saying one or the other is right; all I'm suggesting is these are very difficult judgmental issues, and we have tried to balance the circumstance.

If I could turn to Mr. Roberts just briefly for one quick question.

You represent one of the more significant banks in the country. What is your personal view on this issue of commerce and banking? Is it something that works in our society or would you have difficulties with it?

Mr. ROBERTS. Mr. Chairman, I can say historically the ABA's position has been that we do not want to cross over that line and commingle finance and commerce.

Now, let me step back from that a moment. From my own viewpoint, it seems to me that what was considered "commerce" years ago may be considered "finance" today. Let me give you a more specific example.

Years ago, I would have considered telecommunications as being in the arena of commerce. Today, I'm thinking that telecommunications is a conduit for the delivery of products and/or services of financial nature; and therefore, I am putting it in the financial category.

Being intellectually honest, I'm trying to let you know I'm debating that issue myself, and I'm moving a little to the other side.

Chairman LEACH. Fair enough.

Let me turn to Mr. LaFalce.

Mr. LAFALCE. I really appreciate that candor, Mr. Roberts, because I think all of us have in our minds conflicting viewpoints on these issues because there is no right or wrong. We're trying to, as the chairman said, referee divergent points of view when there is validity to virtually all perspectives, and we're trying to come up with something that might best serve the public interest. It's tough.

Mr. Meyer, when you referred to Chairman Leach's bill as pariah legislation, I initially thought that you were being much, much harsher. I thought you were referring to it as FIRREA legislation, and that would have been far, far worse.

It reminds me of when Chairman Gonzalez or former Chairman Gonzalez took a swing at somebody down in Texas, and people thought that the individual had called Chairman Gonzalez a com-

munist. He said, "No, no, no; he called me a columnist. By far worse." [Laughter.]

Let me paint a scenario for you.

We have a bill introduced by Chairman Leach, and that carries a lot of weight because he is chairman of the Full Committee. We have a bill introduced by Congressman Richard Baker, and that carries a lot of weight because he is the chairman of the Capital Markets Subcommittee. We have a bill introduced by Senator Al D'Amato. That carries a lot of weight because he is chairman of the Senate Banking Committee. It's very similar to the Baker bill except that it's a bit stricter with respect to the firewalls provisions, as I understand it.

Because of the great deference shown to the chairman, let's suppose the House adopts the Leach bill, the Senate adopts the D'Amato bill, and we've got a number of us in the Conference Committee: Doug Bereuter, Dick Baker, myself, Al D'Amato, what have you. But there are a few little hitches there, too. There are some other banking problems we want to deal with. I argued during FIRREA that sure we have the right to break contracts, but not without paying damages, and those damages are going to be quite extensive.

A few days ago, Ricki Tigert says, yes, we're going to have to come up with $15 billion perhaps to pay damages for breaking those contracts with respect to goodwill. Well, we got some money from the RTC. We might be able to use that for it. That creates budgetary scoring problems. Of course, a lot of the SAIF institutions are viewing that RTC money as one means of dealing with the potentially great problem of premium disparity, not only because of the longer period of time it's taking to reach adequate capitalization ratios for the SAIF institutions, but because of the outstanding FICA obligations.

Senator D'Amato and I asked GAO for a report, which we received last week. And Senator D'Amato in this scenario of mine is going to attach some type of resolution to his bill. So when we go to conference, we're going to have all these issues: Glass-Steagall, the unitary trust issue, the BIF/SAIF issue, the damages issue.

We go to the five of you and we say, we have to compromise, what's your recommendation for the compromise we should reach in the Conference Committee? Who wants to talk to me about what an acceptable compromise might be, because we've got, you know, D'Amato and Leach, we've got the BIF/SAIF problem, the FICA problem, the damages problem, and we want to do it in one enchilada.

Mr. MOUNT. I'd like to address that for just a second. I guess, if you are going to take a look at all the proposals that are out on the table at this point in time with regard to——

Mr. LAFALCE. That's not an unrealistic scenario that I just painted.

Mr. MOUNT. No, I know it's not.

With regard to Glass-Steagall, with regard to the Bank Holding Company Act, I would certainly feel at this point in time that we would be more in line, and this is not a total commitment, but we would be more in line with Chairman Leach's proposal at this point in time, far more so than we would be with the Baker proposal,——

Mr. LAFALCE. I understand that, but Congressman Baker is on that Conference Committee, and Senator D'Amato is on that conference committee, and so forth; so, you know, where are we going to give?

Mr. MOUNT. In my opinion, we don't have a whole lot we can give.

Mr. LAFALCE. Thank you.

Mr. MEYER. Mr. LaFalce, my understanding is that with regard to the——

Mr. LAFALCE. Excuse me. You have a place you can give, I'm sure, Mr. Meyer. [Laughter.]

Mr. MEYER. The claims against the government, my understanding is that they would not be paid out of the FDIC, that the Justice Department has a fund of its own. Whenever the government is sued, the monies that are paid out come through the Justice Department; it would not come through the FDIC. So how that linkage was made, I'm not sure, but I think it's an inaccurate linkage.

Mr. LAFALCE. Mr. Freeman.

Mr. FREEMAN. I think that the issue really is how many linkages do you want to throw into the conference. I have no idea how you resolve the conference. But what the bill at hand here is, is one that addresses financial reform. You can add to that, I'm sure, some agenda somewhere that says that you ought to include some kind of CRA piece to it, you ought to settle the SAIF/BIF issue, you ought to do this and that. The point I was trying to make in the testimony was that that's what I would exclude—extraneous amendments—and there's plenty of opportunity to add, you know, a legion of things on there. I would certainly hope that you could hold the bill to the issues at hand, which are financial reforms, and I don't think any of those deal with that.

Mr. LAFALCE. Thank you.

Chairman LEACH. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Gentlemen, thank you very much for your testimony. Mr. Roberts, representing the ABA, I will ask you first a question.

As you know, both the Leach bill and the Administration bill require banks to have greater than minimum capital standards before they can affiliate with securities firms. Does the ABA agree that banks should be better capitalized to conduct new activities, and, if so, what should the higher standards be?

Mr. ROBERTS. Sir, I definitely believe that the definition of well capitalized institutions should be applicable in the affiliation of securities operations and so forth, and I think to prove that, you can look at the institution in which I am employed, and I think it speaks for itself, that we in practice endorse not only quantity of capital, but I would add to that quality of capital as well, and I think you have to zero in on both the quantity and quality issue.

Mr. BEREUTER. So you're referring to the specific definition when you say that?

Mr. ROBERTS. Quite frankly, the equity position plays a major role, in my mind.

Mr. BEREUTER. Is there anyone else who would like to respond to this question?

Mr. Freeman.

Mr. FREEMAN. I would certainly concur that strong capital is a major component of any kind of evaluation in terms of what we would consider better equipped, but I think you also have to consider management. There is a combination of different kinds of capital, whether it's in reserves or real capital, and management capability that are regularly determined by the regulators, and I think that the regulators really ought to bring their views to bear on what is a capable institution or an institution that ought to be allowed to expand.

Mr. BEREUTER. So that requirement, you would suggest, would be over and above the capital itself, an additional requirement and not in place of the specified level of capital; is that correct?

Mr. FREEMAN. I think that you really have to look at what is a well managed institution in terms of its management as well as its capital.

Mr. BEREUTER. Is there anyone else who wanted to respond to the question?

[No response.]

Let me ask this question, then. Perhaps I'll start with you, Mr. Roberts, again.

The ABA's opinion on the provision of the Chairman's bill, which repeals the unitary thrift holding company exemption but grandfathers existing unitary thrift holding companies, what's the ABA position on that, if there is one?

Mr. ROBERTS. We really don't have a position on that issue, sir.

Mr. BEREUTER. Do you have any thoughts yourself to share?

Mr. ROBERTS. Right off the top of my head, I would rather not comment.

Mr. BEREUTER. Is there anyone who would like to respond to this question?

Mr. MEYER. I would like to make a comment, if I could, related to your question, sir.

Mr. BEREUTER. Mr. Meyer.

Mr. MEYER. And that is that if you take an institution—I'll use my institution as a good example of why I think grandfathering the way it's currently proposed would not work.

Our institution has been designed as very non-traditional. We're quite traditional on the asset side in the sense that over 85 percent of our assets are invested in single-family residential mortgage loans.

On the other hand, we do a lot of things that are very non-traditional. We are over $400 million in assets; we have one branch office; we generate deposits from around the country; in our affiliation with our parent company, we do some inter-company activities. Should our institution, our parent company, desire to sell us, my estimate is that on an open market, our institution would have a value less than book to other institutions, to other financial institutions. On the other hand, if we were being sold to a company that had a structure somewhat similar to our parent company, our value would be significantly above book.

So I think that there is some real risk in looking at not only why the company was created, but what is the structure and what do you have in terms of market value.

Mr. BEREUTER. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you. If you would yield for just a few seconds.

Mr. BEREUTER. I would be happy to yield.

Chairman LEACH. Let me just stress, as a legislature we have to make decisions based upon what's right or wrong in a philosophical circumstance. Our first concern cannot be whether an institution is valued at book or below book.

The reason you would get a premium on a given circumstance is because current law allows an advantage over all other market participants. So other market participants say, is that fair to them? All this legislation does is maintain the status quo for you. Because you can buy other institutions and keep the current advantage, it is an advantage you have compared to Mr. Mount or compared to Mr. Roberts or compared to Mr. Freeman or Mr. Croessmann.

So I would stress to you, sir, that you have advantages in law today that are maintained, but they are advantages that I have some suspicion should not be expanded. But your dilemma that you are more valuable is valid under current law, but why should you be in any different position than Mr. Mount when he sells his bank? I don't know.

Now, as you know, sometimes banks or S&Ls are worth book, sometimes below book, sometimes above book. It's a matter of market valuation. To sell at an advantage over other financial institutions versus at a disadvantage, that is something the U.S. Congress cannot be too sensitive to.

Mr. MEYER. I would agree, Mr. Chairman; however, markets all clear at a price, and if there was a market perception of this significant advantage of unitary holding companies over commercial banks, then you would naturally see a flood of commercial banks converting to thrift structure. There is no evidence of that, which would indicate to me that the market is not perceiving an advantage.

Chairman LEACH. Well, I appreciate that. That's for thrifts, but not necessarily for thrift holding company structures.

In any regard, let me just stress that you have been given an advantage, you are allowed to maintain the advantage under this bill. Whether you should be given an advantage so that you can sell your asset instead of continuing to operate as you currently do is another philosophical leap that is certainly something that this committee in its collective wisdom will have to deal with. I am confident—and just to tell you, I don't think it's a black and white case. I think there's reasonable judgment on both sides. But it is not an overwhelmingly compelling case, but it may be that in the majority view, you may prevail. But I just want to stress that it isn't one way.

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman. My regret that I wasn't here to hear all of the testimony. I had another commitment.

Mr. Chairman and Members, I think there are a number of elements here in this that are, I think, key. One, of course, is that most of the panel subscribed to the fact that the risk factors in terms of commercial banking and investment banking, other types

of powers that are being sought here, are really not that much different today.

There has been a circumstance, for instance, where financial institutions have derivatives, others have derivatives as an example of the latest concern that, in a sense, that risk issue has inherent in Treasuries and other types of investments.

On the bank side, I might add parenthetically, Mr. Chairman, that the response to that has been to try to put in place capital as a way of dealing with the problem, and in a way, my way of thinking, it's sort of a—while it's very comfortable, and I'm not advocating breaching any of the capital standards, I think it has a limited utility in terms of it may be the only thing we have, I mean, but it is a limited utility.

But most of you at the table, I take it, agree that the risk issue is no longer a factor. In other words, ostensibly one of the reasons that this legislation passed is that it characterized commercial banking and investment banking as substantially different in that there are different amounts of risk, they are inherently different, commercial banking. But today I guess most of you at the table feel, I guess Mr. Mount, Mr. Roberts, Mr. Freeman all feel that that's the case, that there is really a product here or a risk that is not substantially different.

Anyone have any differences on that?

Mr. FREEMAN. No.

Mr. VENTO. So I think as you go down this path one of the other questions is with regards to one of the other concerns, is the issue of bank capital and the use of bank capital or—I say we're concerned about that from the standpoint of the insurance side, that we put so much credit in the—we put so much dependence, I should say, on the credit issue or on the capital issue that we are concerned about the use of that capital.

How should we or how could we restrict the use of bank capital as an effort here to leverage in, to merge, or to—how should it be limited in terms of how it's used in terms of investment banking? Because we have a proprietary interest in this with regards to the taxpayer subsidy, the safety and soundness of banks.

As I said earlier, maybe we are overrelying on it, not that I am advocating changing it. We have been advocates of stronger and stronger capital. I have a hard time getting stronger than the chairman is on capital standards most of the time.

Anyone have any comments about safeguards that are necessary?

Yes, Mr. Freeman.

Mr. FREEMAN. Well, I think that you have in place already safeguards in a number of ways, not the least of which is 23A of the Federal Reserve Act, which limits the amount of capital or loans, I believe, that you can make between subsidiaries of a bank holding company.

If you just look at the penalties under FDICIA and FIRREA, and as a CEO of a fair-sized institution, it has my attention that the both civil and criminal penalties that are attendant really do make you focus on risk.

We also need to keep in mind that the business of banking is risk. We deal with risk every day in terms of loans and the management of our portfolios, all of that. The question is where are the

risks in the securities business and which ones of those and how do you manage them.

Mr. VENTO. Yes. I think the concern, of course, is that the—I mean, that's a given. I understand that there has been sort of a broader range of this risk, that they are not so different. That was the basis on which I started and obviously not a very exciting question, I guess, because there is agreement on it.

Fundamentally, when this law was written, that wasn't the case. They thought there was a different character. There may be a different character, but they thought there was a substantially different magnitude.

One of the other questions is the conflict of interest issue, and, of course, the taxpayer subsidy. But one of the questions I wanted to get to, and I would like to have gone over these more carefully with each of you, and you may want to respond to that, but one of the issues, of course, is dealing with the regulation.

As you mentioned 23A and 23B—you know, one of the fundamental tenets of this is that the regulator, of course, is paying attention. Now we find the regulator in the case went out and signed a lot of contracts and good will. We thought we could correct it after the fact. Apparently, some things we can't.

But the fact is that what the regulator does in terms of these issues—should we be setting in place a mechanism—I guess we're not going to be able to do this all at once; you know, expanding problems doesn't solve them. And so putting in place some mechanism to, in fact, change the regulator or reconfigure the regulator after additional powers are granted, should we put in place some mechanism to achieve that sort of reconfiguration of who the regulator is?

You know, most of what happens in these bills is that everybody feels comfortable with the regulator that they have. We found that out last year when we were trying to deal with regulatory reform, and others have found it out earlier. They all feel very comfortable with it. They want to get the powers and kind of not get into the turf battle with the regulators. I understand that. That's pragmatic. But is it realistic? Should we be putting in place some mechanism to bring back to Congress, maybe force us to look at reconfiguring the regulators in this instance, because I don't really know how this is all going to pan out. Maybe the Federal Reserve Board is as good as my colleague from Iowa thinks. Maybe they are not.

Anyone have any comments about that?

Mr. CROESSMANN. I'll try that one.

To us, I think what matters most is not so much who is the regulator, but the fact that any organization engaged in the same activity is regulated in the same way by the same regulator, and that's the paramount consideration and concern that all of us have, I think, in the industry. To the extent that we can work on a mechanism to help create that and to ensure that, I think the competitiveness that we're all seeking would be enhanced rather than diminished, and I think that's the chief thing that we have to concern ourselves with.

We found ourselves in our organization, for example, many times dealing with multiple regulators on a similar issue, creating a fair

amount of confusion, of disarray, and really not working in the best interest of the consumer, who ultimately is who we're trying to please here, and creating a fair amount of inefficiency within the organizations that we tend to run as well.

So I think the key thing is the same regulator regulating the same kind of activity, whether it's at a bank, a securities firm, or wherever.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. Mount, I want to have a series of questions——

Chairman LEACH. Excuse me, Richard. Since I took a little extra time, I'm going to yield you a little extra time.

Mr. BAKER. Thank you. And I have been in and out. There's a mark-up in Ag Committee, and I've been jumping back and forth pretty good this morning. Thank you very much, sir.

Before I get into a series of questions, tell me a little bit about Saratoga National and the community, because I hate to admit, I'm not familiar with the community that well. What size community is it and what's the nature of the services you offer there?

Mr. MOUNT. Saratoga is a community really that's kind of blended in with San Jose, California, located right in the heart of Silicon Valley. The population itself is only 36,000, but when it's combined with the Valley, the population is well in excess of 2 million, and, of course, most of the high-tech industry in the United States is located there.

Mr. BAKER. Is business good?

Mr. MOUNT. Business is pretty decent at this point in time, yes.

Mr. BAKER. Real estate demand down a little?

Mr. MOUNT. Real estate demand is relatively slow and———

Mr. BAKER. Down from 1993 to 1994?

Mr. MOUNT. And has been for the last 4 years.

Mr. BAKER. And loan to asset ratios still kind of low?

Mr. MOUNT. Loan/deposit ratios are somewhat weaker than what we would like to see them, although that is improving at this point in time.

Mr. BAKER. So that you would say that something is happening to your traditional marketing base being adjacent to a community like San Jose with a dynamic economy, with a loan to deposit ratio of 42 percent, with real estate loans down from 1993 to 1994. Looking at the market and where you go, somebody has got to be getting those customers, and the question is where are they going? And since you are in a community of 36,000, you don't qualify under the town of 5,000 loophole for the sale of insurance, do you?

Mr. MOUNT. No.

Mr. BAKER. OK. Do you advocate elimination of that loophole?

Mr. MOUNT. No, I don't advocate elimination——

Mr. BAKER. So sale of insurance might be OK under certain circumstances?

Mr. MOUNT. Under certain circumstances, yes.

Mr. BAKER. OK. In the event that I were to close a loan at your institution—most institutions have a little box at the bottom that you check off called credit life. Is that on your forms?

Mr. MOUNT. No, it is not.

Mr. BAKER. Do you think we ought to advocate that be eliminated from most bank closing documents?

Mr. MOUNT. It's a product that we have purposely not offered——

Mr. BAKER. Is it risky?

Mr. MOUNT. In our particular bank.

Mr. BAKER. Is it risky?

Mr. MOUNT. No, I don't think it's necessarily risky.

Mr. BAKER. So you necessarily don't think it's——

Mr. MOUNT. The type of lending that we do, it's not necessary for us to offer that type of product.

Mr. BAKER. And as a policy matter, do you believe the IBAA would be for or against the check-off box for credit life insurance? Don't know?

Mr. MOUNT. In my opinion, I'm not sure that they would be for that.

Mr. BAKER. OK. So we're no on credit life, but we're yes on town of 5,000.

Do you support the repeal of Glass-Steagall?

Mr. MOUNT. No, we do not support the repeal of Glass-Steagall.

Mr. BAKER. Interesting.

Should banks be restricted in business activities that, in our agreed-upon view, is risky to the taxpayers' deposit insurance? For example, I'll be specific, derivatives trading. I would presume your institution does not have any interest in touching derivatives.

Mr. MOUNT. No, we do not.

Mr. BAKER. Do you believe that the reason for limiting the expansion of bank products is due to the inherent nature of the products you might sell, that the risk you might assume would be unreasonable and thereby lead to a raid on deposit insurance funds?

Mr. MOUNT. That's certainly possible.

Mr. BAKER. Should we, therefore, on that basis, then outlaw the sale of derivatives?

Mr. MOUNT. No. I think that if you have a situation where the larger banks especially are involved in derivatives and fully understand what they are doing, no, I don't think that that should be cut out. I think with the smaller banks, they don't use the product.

Mr. BAKER. What about the sale of—or rather, not sale—the underwriting of municipal revenue bonds. Is that a risky proposition?

Mr. MOUNT. No, it's not a risky proposition.

Mr. BAKER. So you would be supportive of banks engaging in that activity?

Mr. MOUNT. Yes.

Mr. BAKER. So if we were to look at the world that the IBAA now purports—oh, one other question. Since risk aversion is the principal goal of the IBAA's position, do we——

Mr. MOUNT. I hope risk aversion is the goal of all of us.

Mr. BAKER. Oh, certainly.

Mr. MOUNT. Not just the IBAA.

Mr. BAKER. I'm trying to understand.

Do you think that based on the practices of the 1980's and 1990's with regard to banks and thrifts, that real estate development loans should be greatly limited?

Mr. MOUNT. I think that real estate development loans should be looked at very carefully in terms of underwriting guidelines. I think they became very lax in the 1980's.

Mr. BAKER. Do you think——

Mr. MOUNT. I think public policy made some changes——

Mr. BAKER. I'm sorry, but I'm getting close and I don't know how far I'll be able to go on my questions.

Mr. MOUNT. Yes.

Mr. BAKER. I don't want to not allow you to answer, but the chairman may give you broader discretion to respond.

Chairman LEACH. I would certainly like to give you a little broader discretion, Richard.

Mr. BAKER. Thank you.

With regard to the issue of startup businesses or small business loans, do you think they should be more sufficiently guarded against because they tend to be, along with real estate development loans, the most risky loans a bank can make? Should we require even higher capitalization levels against those types of activities?

Mr. MOUNT. No, I would disagree with that, only from the standpoint that in a community bank, those startup businesses—the people that are starting the businesses, we know them and know them very well, they have been in the community for a long period of time, and you look a little bit more at character there than what you may look at balance sheets. So, no, I would disagree with that.

Mr. BAKER. So you generally think that real estate development loans, startup business loans, activities of that sort, broker sale of insurance within the bank, perhaps credit life, perhaps underwriting municipal revenue bonds, those are all acceptable commodities for banks currently regulated to engage in without reason of risk being a concern?

Mr. MOUNT. Again, in a community bank, where you know the customer, yes, I would agree with that.

Mr. BAKER. What about real estate brokerage? Is brokerage the issue or is it the product that's the issue? If you are going to allow banks to sell insurance, should they be allowed to sell real estate?

Mr. MOUNT. No, I don't think they should be allowed to sell——

Mr. BAKER. So what's the distinction in risk between the sale of an insurance product and a real estate product? You are only at risk for the brokerage fee and nothing else. Is there a difference in your mind in the two products?

Mr. MOUNT. Yes, I think there is. Basically that risk being that, as far as the real estate product goes, it can change in market value over night.

Mr. BAKER. But you don't own it; you're only acting as a broker. I'm not advocating the ownership and sale and direct investment in real estate; we all know that's risky. I'm simply saying as to the brokerage element that we are allowing under the insurance rules that you say is acceptable, why not allow real estate brokerage? It's the same activity; we don't own it; we're simply marketing it and we get a commission. If the sale doesn't close, we don't get anything. Is that an unreasonable extension of practice for a bank to be involved in?

Mr. MOUNT. In my opinion, it is.

Mr. BAKER. OK. Well, then, as I'm understanding the view, it's a product-by-product analysis.

Mr. MOUNT. Right.

Mr. BAKER. There are some things we should do and some things we shouldn't, but it relates to the product and not the inherent business practice.

See, I have trouble with that. In light of the statement with regard to un-American activities in the written record here, I think it's un-American by contrast to tell someone what product they can or cannot market as long as there is no untoward risk assumed by the taxpayer.

Let's say for a moment we can't reach agreement on which products can or cannot be sold, but we agree there is risk in the marketplace. Let's talk about derivatives.

If someone wishes to engage in derivative sales and you say we shouldn't limit them, as I believe you said earlier, should we do something to protect taxpayer interest and talk about deposit insurance? Should we not allow deposit insurance under its current structure to be fully offered to an institution which engages in derivatives practices simply because they engage in those products or services, or do you believe at all cost deposit insurance in its current form should not be modified in any way whatsoever?

Mr. MOUNT. I don't believe deposit insurance should be modified at this point in time.

Mr. BAKER. So that if we don't limit the taxpayer risk by taking the insurance policy away, then our only choice is to pick and choose which products banks may be able to offer within their service window.

Mr. MOUNT. Congressman Baker, one of the problems you have, I think, is you're dealing with two entities here. You are dealing with a large bank environment and a small bank environment, and I think the two are distinctly different.

Mr. BAKER. My point exactly.

Mr. MOUNT. OK.

Mr. BAKER. Now, if we were able to devise a system where we could leave $29 million institutions alone with multiple accounts insured, with limited product diversity, and you could go on your merry path and sell exactly what you sell, and there was another system whereby larger institutions who wanted to engage in broader risks with lesser deposit insurance coverage available to them as a result of engaging in that risk, would it not make sense for you to have two parallel sets of regulation allowing capital to be used in the marketplace where business owners deem it best rather than having the government set regulations in place which determine profitability?

Mr. MOUNT. In a perfect world, yes. But this is not a perfect world. I think the problem you have there is the fact that there is no way that you can possibly guarantee this industry, that too-big-to-fail is going to go away, regardless of what you do with deposit insurance.

Chairman LEACH. Would the gentleman yield for a question?

Mr. BAKER. Just one second and I will be happy to. I want to follow up just on that point. I will be glad to yield.

Chairman LEACH. I just want to get a clarification because I am learning a lot from——

Mr. BAKER. By all means, I would be happy to yield. I'm sorry, I misunderstood.

Chairman LEACH. You talk about lesser deposit insurance. What do you envision when you ask that question or when you suggest that?

Mr. BAKER. I am just talking philosophically. I don't have a proposal to put before the gentleman this morning but I think it is something that we should recognize. If we are going to allow financial market players to get in things when we don't fully understand the associated risk, we should back off a little bit from what the taxpayer is willing to underwrite. That is open for discussion.

Chairman LEACH. A lesser amount would be possible?

Mr. BAKER. Yes, sir.

Chairman LEACH. Thank you. Please proceed.

Mr. BAKER. Sure. And I think I have abused my time.

Chairman LEACH. If you would like one more question, you are free.

Mr. BAKER. Just as a followup, I do appreciate the chairman's extensive courtesies this morning because it is a big subject and we have touched a lot of areas and I hate to be so quick in moving from one to the other and would be more than welcome to speak to Mr. Guenther at his convenience or others about the development of this plan when he has occasion to come by.

But the principal interest here is devising a system that would allow both interests to survive in a modern, changing world. I think we can agree on this. Is the biggest threat to community banking in America really the growth and expansion of large banks or is it more appropriately the risk that we assume from the growth of nonregulated financial entities who offer every conceivable financial service available without regulation except checking accounts and some of those money market funds look pretty funny to me. What do you think?

Mr. MOUNT. I think the risk is in both areas. I don't think you can say it is one or the other, I think it is both.

Mr. BAKER. Thank you. I appreciate your courtesy.

Chairman LEACH. Before turning to this side, let me just stress that in the bill I have introduced we have a holding company structure. That holding company structure is designed to take nonfederal insured deposits and put added capital at risk. Using that holding company structure takes the risk out of the system for deposit insurance.

If you work within a subsidiary structure as the Administration suggests, you obviously increase the risk to the deposit insurance system. But the technique we have developed is one of taking activities that may or may not be riskier and requiring them to be dealt with in a separately capitalized circumstance.

Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. Mr. Roberts, on page 9 of your written testimony, you state that sections 23A and 23B insulate banks from their affiliates and effectively restrict harmful loan security transactions between banks and their affiliates. Yet history has shown, for example, in 1987 Continental Illinois Bank succeeded in trans-

ferring funds to its security operations of the bank holding company under the very noses of the FDIC and the OCC regulators who were actually at the holding company monitoring real time transactions and we're also very much aware of what has just recently happened to the 200-year-old British merchant bank, Barings, which just collapsed as a result of one of its rogue security traders.

These are reasons why I, and I know others, have been very skeptical about the durability of firewalls. Adding to that skepticism, last week Chairman Greenspan said in his testimony that "firewalls melt in times of crises." Could you comment on that and hopefully help make those of us that are skeptical feel a little more secure as to the fact that these firewalls will in fact work. What has happened to change things or to make them stronger so that we don't see the kind of abuses that have happened in the past?

Mr. ROBERTS. I will be glad to comment on that. You really cover the whole waterfront in that question so I may break it down a little bit.

Number one, 23A and 23B very much limit the terms and conditions of transactions between affiliates within the holding company to be like terms and conditions with outside parties and so should be very effective in isolating and protecting the capital of the insured institution. Let's take each of your examples one at a time. What actually precipitated a difficult situation at Continental was liquidity, not capital.

As you probably recall in the state of Illinois, there was at that time no branch banking and Continental basically relied on the wholesale funding market for the institution. That is, they had to go out and buy funds external to the market as opposed to someone, let's say, like Bank of America, who has a very dispersed base of core deposits. As you recall, that was the first time the Eurodollar market participants actually turned their backs on selling funds into an institution.

Your other point, with regard to the most recent Barings episode, could even be broader to include such things as Orange County and Procter Gamble. When you look at what caused these problems, it is really not the transactions, it is not securities, it is not derivatives. What really is a problem is the lack of controls, lack of adequate policies and basically flawed individual strategies. I contend those are what caused the problems.

I will also tell you that our own institution runs itself using prudent, smart best business practices, and that is the key to limiting risk. I don't really believe that properly constructed firewalls and so forth will melt down, particularly in the current regulatory environment, even to the point of having cease and desist orders. Also, internal management controls and also external checks and balances, including external audits bring to surface very quickly any "abuse" that may take place.

Ms. ROYBAL-ALLARD. My next question is for Mr. Mount. Secretary Rubin talked about a one-stop-shopping concept whereby community banks could offer their customers a broad range of financial service products. In addition, Mr. Greenspan suggested that community banks that have established relationships with area businesses are in a unique position to provide such businesses

with access to the capital markets. Could you comment on their positions.

This was in the response to whether the repeal of the Glass-Steagall Act would benefit or hurt community banks.

Mr. MOUNT. The problem I see with that, of course, is the fact that the community banks, most of them, do not have the capital, the expertise, the wherewithal to actually get involved in some of the issues that the major banks would be able to get involved in. So I don't see any real advantage to repeal of Glass-Steagall for the small community bank because they are not going to get into that integrated market like the major banks.

Ms. ROYBAL-ALLARD. Thank you.

Chairman LEACH. Thank you.

Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. Good morning.

I wonder if I could address a couple of questions to Mr. Mount, if I could, just to clarify a few points. I understand that there has been an expression of concern about the repeal of Glass-Steagall. Does that extend to any of the reform proposals within either Mr. Leach's bill, Mr. Baker's bill or the Administration's proposal? Is there anything in there you think has got merit?

Mr. MOUNT. Yes, I think there are certain items within the Leach bill that do have merit.

Mr. LAZIO. Which are they?

Mr. MOUNT. Number one, of course, is the Federal Reserve remaining the regulator for the holding company. I think that is extremely important. I think the firewalls that have been built into the Leach bill are far stronger than what we see in both the Baker bill and also the Administration bill.

We still have some concerns about firewalls. I tend to believe that in the case of an emergency, those firewalls will melt and it doesn't make any difference how much capital you have. Take a look at the Barings bank as a prime example. I am sure when they were trying to protect their own funds that they had built in firewalls and protections and those failed and if they failed on that basis, I don't see that you can assure me that you are going to be able to put any regulatory firewalls in that will not fail in a like situation.

Mr. LAZIO. Would you advocate the continuance of the status quo in terms of competition and diversity?

Mr. MOUNT. I would advocate that, as far as the community banks go, we at this point in time do not completely favor repeal of Glass-Steagall. However, we are well aware of the fact that change happens. We just want to make sure that whatever changes are made are well thought out before they are made.

Mr. LAZIO. Are you prepared to advocate the change that you are talking about?

Mr. MOUNT. I am prepared to say that we have more faith in Congressman Leach's proposal than we do the other two proposals at this point in time and we need to study that proposal in more depth before we make a final decision.

Mr. LAZIO. Is there anything, any regulatory change that you could envision, that would increase or allow increased competition

would allow your members' portfolio or asset portfolio to be broadened or diversified that you think you could support?

Mr. MOUNT. I think we could support a lot of things. Number one is regulatory relief. I think if we had that, we could become far more competitive than we are now. I think you need to look at CRA. I think a reformed Federal Home Loan Bank System is extremely important.

I guess my concern is some of the issues we see coming up, deposit insurance as another example, FICO, SAIF in my opinion are probably more critical to our industry right now than spending the time with regard to Glass-Steagall.

Mr. LAZIO. Is there anything focusing on the subject matter within the hearings that we have had so far in Glass-Steagall that you feel would behoove your member banks in terms of increasing competition? Maybe I should frame that a little bit more tightly.

Mr. MOUNT. I think you should.

Mr. LAZIO. Could you answer that question?

Mr. MOUNT. That is a wide open one.

Mr. LAZIO. In terms of what we have discussed in these hearings, is there anything, any regulatory change that you can envision that would behoove your member banks?

Mr. MOUNT. I think some of the proposals in Chairman Leach's bill, yes, we could take a look at that. They would need further study but it is something that we would certainly be willing to look at.

Mr. LAZIO. I'd like to—and I know my time is running out as well—if I could just ask a question of Mr. Roberts.

I wonder if you can express the ABA's position on the two issues, really, the nonbank bank and the provision which repeals the unitary thrift holding company exemption but grandfathers existing institutions. Could you give us some?

Mr. ROBERTS. I would like to get back to you on that after checking with the ABA in order to be very specific with you, if that is all right.

Mr. LAZIO. OK.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Lazio.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I want to address my question to Mr. Roberts and Mr. Mount.

Last week, Chairman Greenspan was questioned on the danger of a concentration of economic power in very large financial institutions under the proposals before this committee. His response was that small institutions have a competitive niche that large institutions won't be able to breach.

Mr. Roberts, do you agree? Will small institutions survive Glass-Steagall reform?

Mr. ROBERTS. Will small institutions do what now?

Ms. VELAZQUEZ. Will survive Glass-Steagall reform?

Mr. ROBERTS. Oh, absolutely. I have no doubt in my mind on that.

Ms. VELAZQUEZ. Mr. Mount, could you comment on Chairman Greenspan's comments? What would be the impact for consumers

if small institutions experienced greater competition from large institutions?

Mr. MOUNT. I think it would make it a much more difficult situation than what we are facing today. We just don't have the resources as a small bank to provide the types of services that are being discussed today. We don't have the financial resources nor do we have the people to do that. So, yes, I think there would be an effect on the small community bank.

Ms. VELAZQUEZ. Mr. Roberts, in his testimony, Mr. Mount suggests that banks might be tempted to allocate credit to affiliates with Glass-Steagall reform, even if that would not be the most productive use of that capital. If I understand your position, you contend that Glass-Steagall reform would lead to greater efficiency.

Can you comment on Mr. Mount's statement?

Mr. ROBERTS. I will be glad to. If you look at the earnings equation of a financial institution, you have interest earned on assets, you have interest costs on deposits, you have other income, other expenses, taxes that equal bottom line. The more diversification you have in that "other income" category, the more you smooth out the cyclical nature of earnings, and one counterbalances the other. In other words, the more sources of revenue, the more stable the revenue stream should be and therefore the retention of capital over time should be enhanced.

Ms. VELAZQUEZ. Would you like to respond, Mr. Mount?

Mr. MOUNT. You know, that's fine if, again, you are able to offer all those services that the major banks are able to offer. All I am saying is a community bank, a $40 million community bank in a rural community, simply does not have the resources to do those things, thus they would be at a competitive disadvantage.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Ms. Velazquez.

Mr. Royce? Excuse me, Mr. Royce. We haven't called on Mrs. Roukema. No?

Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

The debate that we have today on Glass-Steagall comes at a time that is rather precarious for the U.S. economy. The dollar has dropped to new lows against many foreign currencies, Mexico continues its downward spiral despite intervention and investors in Japan are in a major cash crunch that does not seem to be letting up.

In our heavily globalized market, I am wondering if the U.S. banks and the stock market and the commercial investments are not in more danger than we are willing to admit. And my question is, in what ways do you believe financial modernization strengthening through the types of bills we are talking about today will help the banking industry in future competing markets both domestic and abroad.

I will ask that of Dick Roberts. If I could get inside your head, Dick, and ask you for your thoughts of where this will take us at this precarious time.

Mr. ROBERTS. Thank you, sir.

The first issue you raised is one of intervention in the currency markets. First of all, I don't think intervention is a long-term cure;

it is a short-term band-aid. So the central banks can perform intervention and you may get some balance but the fundamentals have to be in place for currency parities to be stable.

In order for currencies to be in stable parity between trading partners, let's say, then you need a healthy economic environment. And a healthy economic environment requires an ability to transfer capital around in an efficient, quick, low-cost manner. This provides a foundation for a strong economy which then provides a foundation for a strong currency.

Mr. ROYCE. Let me follow up with another question for you, Dick. The Treasury Department as part of its financial modernization package is proposing that an interagency committee be established to determine capital standards for holding companies that have less than half their assets in banks and thrifts.

Do you support the creation of such an interagency committee and do you think that is necessary for capital standards?

First I'll ask the position of the organization but then I would like to just have some of your own views on that.

Mr. ROBERTS. I believe and the ABA believes in functional regulation and, by setting up this council, it seems like we are getting so many hands in the pie that it may be a cumbersome organization. I quite frankly go back to the functional regulation as opposed to the council made up of many, many different ones.

Mr. ROYCE. I see. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I have a few questions I would like to ask. The first is—I meant to ask this last week when we had some of the regulators in, but I will ask this group.

We talked a little bit about revenue bond underwriting and obviously there is a difference between a municipal revenue bond and a general obligation bond. The question I have, and I just don't know, in the proposals that are before us, if we grant that authority, is that going to cause any differential in the regulatory structure between a bank and a broker/dealer in terms of capital requirements?

Mr. ROBERTS. Could I take that, please? I absolutely positively endorse the structure that the chairman has put in his bill that allows municipal revenue bond underwriting in the bank, and the reason I do that is that the expertise has long resided in the bank on underwriting or investing in or making a loan to municipal issuers.

The banking unit is the closest to that local community as well and knows it better than any far-removed, let's say Wall Street people, who may or may not even care to go down to the really small local community.

But in addition to that, I believe strongly that this country is about to face a very serious problem with our infrastructure. We have road systems that really are in disarray, bridges that you read about in the newspaper where a piece of concrete hits a person in the head as he drives down the road, water and sewer systems that are aging and are really crumbling, quite frankly, and

could pose hazards. So I think allowing banks to underwrite revenue muni-bonds is very critical.

Also, by the way, on the issue of risk that I think you are referring to, it could be interpreted, and this is just my view, that possibly the risk on a water and sewer revenue bond (I'm talking about public service revenue bonds) could even be lower than the GO obligation of the municipality because when customers turn their water faucet on, they want some water coming out of there, and they are going to pay their water bill.

Mr. BENTSEN. If I could reserve my time, actually I came out of the municipal bond industry and travelled to a lot of towns and was with a broker/dealer, so I understand the competitive nature. I think you are right about water and sewer bonds may be compared to some other GO bonds, but multifamily housing revenue bonds, maybe that is not such the case, that there is a little more risk.

But I guess my question is not so much related to risk, and I would like to ask some others, but is there going to be any difference in the underwriting requirements that a broker/dealer would have to achieve versus a commercial bank? And I would think that if there is, we ought to look at that because I don't think there should be a difference.

I'm not so sure I oppose the underwriting. Banks already can underwrite certain types of revenue bonds as they are for teaching hospitals and things like that, and I think we ought to maybe make that more uniform.

Let me ask this of all of you all. Last week, we had the regulators here and the chairman of the Fed said that we should look at regulatory reform, in response to a question that I asked, he said that we should look at regulatory reform after we have gone through this process of reforming or repealing Glass-Steagall.

I would ask you whether or not you think that that is maybe putting the cart before the horse, because my question is whether we talk about some form of functional regulation in the different proposals, whether it's Chairman Leach's or Mr. Baker's or the Administration's, they talk about, in particular Mr. Baker, committees of the regulators who will look at these new super banks or new banks that we will have, and I'm curious whether or not, going through this process, that we shouldn't look at this; and second of all, do we run the risk of saying well, we will look at it later, we go ahead and we repeal Glass-Steagall or do what we do to it, and then we let that slip and we end up having a cumbersome regulatory regime.

Mr. ROBERTS. That's a complex issue. I mean, one could say it's like the chicken and the egg here.

I think the proper approach would be to try and parallel as you go through step 1, step 2, on, let's say, the repeal of Glass-Steagall, and the way that unfolds, then you have a parallel on the regulatory side as well. So by the time you get to the closure, the structure falls out automatically.

Mr. FREEMAN. I think I agree wholeheartedly. It seems to me, though, that you have to decide what kind of a system you want, and then you design a regulatory system to take care of it. To set the regulatory system before it, I think, puts handicaps in place or

hurdles that do not make for a smooth-running organization. So, I mean, let's decide what you want to do for the banking industry and then let's put the overlay on top to protect it.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Bentsen.

Mr. Ehrlich.

Mr. EHRLICH. No questions.

Chairman LEACH. Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman.

Insofar as I understand, we're not really talking about creating any new types of investments here and we're really not talking about creating any new wholly new mechanisms for making those investment opportunities available to investors, large or small, but really what we're talking about here, Mr. Chairman, is basically to some extent changing the way in which existing entities can offer existing investment opportunities to investors.

I would just appreciate some thought from some of these panel members, and I don't mean this to indicate that I am for or against the reforms that we are talking about here. I have a very open mind on this as a new member of this committee. But what does it mean or what would the reforms we're talking about here mean to an average investor, if anything, and I suspect the answer is there is something that it would mean to that average consumer.

Mr. CROESSMANN. If I could perhaps begin on that one, I think you are right, Congressman.

In the case of our institution, for example, in New England, right now customers who might be interested in purchasing deposit products, securities products such as mutual funds, or annuities products, would need to do that through three individuals—three different people and three different structures, which is obviously awkward for the consumer. They really are looking for one person to help them, and yet we have people who work for the bank, people who work for the brokerage subsidiary of the bank, and people who work for a third party firm who actually sell annuities on bank premises. It's inconvenient, it's awkward, it's not what the consumer wants.

So reform would enable us to bring those things together more to the advantage of the consumer, making it much more convenient for him or her to get the information that he or she wants and to be able to do it at one place, at one time.

Mr. BARR. Would other members of the panel give me their response, too, please.

Mr. MOUNT. That's probably true to a certain extent, but that also creates other problems for the consumer. Undue pressure, for example, if everything is centered under one roof, undue pressure to sell a specific product; pricing differences with regard to different products; making a loan to a subsidiary within the bank itself, you know, at a preferential rate, a loan that may have been made to a consumer as opposed to the subsidiary. So I think there are some problems inherent with combining all of them under one roof. I think that you then have the opportunity for a lot of different subs to do things that they may not be able to do if they were kept separate.

Mr. BARR. Yes, Mr. Freeman.

Mr. FREEMAN. Mr. Mount runs a different kind of bank than I'm accustomed to. There are plenty of anti-tying laws on the books; there are all kinds of regulations to prohibit that. The issue is what's best for the customer, and I think by being best for the customer, you will also end up with a stronger banking institution, so the country wins in all.

Mr. ROBERTS. Just a follow-up on what Mr. Freeman was saying.

There are very clear defined suitability rules, guidelines and so forth that, if you are in the securities business, you must follow. There are no ifs, ands or buts. And I don't believe that you would have a problem. And we do run different banks. I mean, that is true.

Mr. BARR. Would this in any way diminish the opportunities or would it enhance the opportunities to a consumer? When they walk in in my district—I have a district that includes some of the Atlanta suburbs, but includes a whole swath of west Georgia, cattlemen, farmers, many, many small businesspeople. Will this enhance the opportunities available to them or are there things that they should be concerned about here?

Mr. CROESSMANN. In my opinion, it would open up fairly broadly the array of products and services that could be offered to those individuals and make it again much more convenient for them to do so, not just the individual products, but the benefit of having them all work together in a very integrated fashion. For people these days who are in many cases time poor, integrated services like this are extraordinarily important.

I wouldn't dismiss the importance of making sure that consumers always know what it is that they are purchasing and what is that they are not purchasing from the standpoint of Federal insurance and that kind of thing. But all banks and all bank programs now have suitability efforts underway that are very rigorous.

The CBA recently completed a study late last year which showed, for example, that of mutual funds investors investing at a bank, 95 percent of them recognized the fact that these were not FDIC insured, and likewise, along the same lines, 85, 87 percent of the people really believed that their investment representative explained the options and explained the options to them very well.

So I think there is an extraordinary added benefit here to having these things being able to be presented to a consumer in an integrated fashion.

Mr. BARR. Thank you.

Mr. Chairman, could I ask unanimous consent just to give 30 seconds to Mr. Meyer to respond to a couple of my questions?

Chairman LEACH. Yes, you may. Of course. Of course.

Mr. MEYER. Thank you, sir.

My comment was going to be that we must remember, one, that we're operating and dealing with products that are already available in the marketplace—we're not just talking about providing products that are singularly going to be provided through banks or thrifts; we're talking about products that are already in existence.

So the competitive nature of the marketplace in which we deal I think would, one, insulate somebody from being steered in the wrong direction, from any leverage that an institution might try to exercise over a consumer.

So I think that with proper safeguards, that adding these products to a list of products that are available through the financial institutions is just going to provide for one-stop shopping. They exist in other places, and if financial institutions are to survive, they are going to have to be able to compete.

Mr. BARR. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Barr.

Mr. Heineman.

Mr. HEINEMAN. Thank you, Mr. Chairman.

As a new member of this committee, I find this dialogue and these presentations very informative, and at this time I'd like to pass.

Chairman LEACH. Thank you. I appreciate that. My own best view is that a background as a police chief has more relevance to some of these discussions than many of us might suspect. [Laughter.]

Chairman LEACH. Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I have no questions at this time.

Chairman LEACH. If there are no more questions, let me thank the panel. In recognizing that there are differences of opinions, all of which mirror what I suspect are conflicting internal views, there is no such thing as not having doubt on many of these issues. So I appreciate very much all of your testimony as we continue to evolve consideration of this particular approach.

Thank you very much.

The committee is adjourned until 2:00 this afternoon, when our second panel will meet.

[Recess.]

Chairman LEACH. The committee will reconvene, and I apologize to everybody. We are in the process of debating one of these issues that is part of the Magna Carta, at least to the Republican Party, the Contract with America, and so we are tied up a little bit more with voting than I would like.

In any regard, our panel today includes the Securities Industry Association, Marc Lackritz; the Investment Company Institute, Mr. Matthew Fink; the Financial Services Council, Sam Baptista; and the American Financial Services Association, Jeffrey A. Tassey. We welcome you all, and we recognize there are going to be some differences of judgment with members and also possibly between yourselves.

Marc, please, why don't you begin.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman.

I would appreciate it if our full written statement be included in the record.

Chairman LEACH. Let me make clear, all full statements will be included in the record, and you are free to summarize.

Please go ahead, Marc.

Mr. LACKRITZ. Thank you. I am Marc Lackritz, President of the Securities Industry Association, and I appreciate the opportunity to

present our views on H.R. 1062, the Financial Services Competitiveness Act of 1995.

We commend you, Mr. Chairman, for making financial restructuring a priority for this committee, and we appreciate your efforts to move the process forward. We believe that H.R. 1062 represents a thoughtful and comprehensive approach to modernizing the financial services marketplace, but we have some serious concerns that it does not fully or fairly balance the competing needs and objectives of all securities firms, commercial banks, and consumers of financial services.

We strongly support congressional efforts to enact comprehensive financial services reform legislation to best serve American consumers of financial services, and to make it possible for all financial services intermediaries to operate more flexibly and competitively both domestically and internationally.

Our position on this issue has evolved over time for two reasons. First, Federal bank regulators and the courts have rewritten the Glass-Steagall Act through strained regulatory interpretations to permit banks to engage in securities activities resulting in a very different financial services marketplace today than was contemplated more than 60 years ago.

Second, many securities firms wish to take advantage of opportunities in banking that are foreclosed to them by the Glass-Steagall Act's prohibitions.

The regulatory assault on the Glass-Steagall Act has created a balcanized regulatory structure that allows exceptions to the rule to become the norm. In short, the Glass-Steagall Act's separation between commercial and investment banking has become a Maginot Line, high jumped in one direction only by regulatory fiat.

Federal banking regulators have, in essence, created a one-way street for commercial banking organizations to engage in a wide array of securities activities while securities firms remain stalled at the entrance ramp to banking. It is, therefore, critical that Congress, not banking regulators or the courts, undertake a comprehensive restructuring of the regulation of financial services that is consistent with the following three principles.

First, competition without Federal subsidies, securities activities should be performed in separately capitalized affiliates of banks, and those affiliates should have no access to the deposits or credit power of a federally ensured bank.

Second, a two-way street, banking firms should have the ability to own full service securities firms, however, full service securities firms also should have the ability to own banks and bank holding companies.

Third, functional regulation, to protect investors and preserve fair competition, one Federal regulatory agency should apply the same set of rules to the same activity engaged in by any financial institution regardless of its charter.

We support the creation of an investment banking holding company which can own uninsured State charter banks because neither the IBHC, nor its affiliates that engage in securities activities, would have access to deposits or the credit power of a federally insured bank. That approach provides the necessary synergies without putting federally insured deposits at risk, or allowing Federal

deposit insurance to create an unfair competitive advantage over firms which cannot be or choose not to be affiliated with a federally insured commercial bank.

Nonetheless, under the act, insured depository institutions could engage directly in certain securities activities and, thus, effectively could support those activities through its insured deposits. We believe all securities activities should be performed only by a separately capitalized affiliate of an insured depository institution.

We also believe that the firewalls imposed by the act are insufficient to prevent potential credit abuses by a bank affiliated with a securities firm. Firewalls should not be subject to significant exceptions and the board's authority should be limited to interpretation, not elimination or even modification of statutorily imposed firewalls.

Moreover, we believe that there is no reason to extend the affiliate transaction restrictions of sections 23A and 23B of the Federal Reserve Act to an uninsured State chartered bank owned by an IBHC.

In addition, the act generally would prevent a company from becoming an IBHC—that is, from acquiring an uninsured State chartered bank. If more than 10 percent of its total consolidated capital and surplus are invested in shares of companies engaged in certain activities such as insurance underwriting activities, or in activities that the board has not determined to be financial in nature, there is no apparent reason why firms that commonly engage in insurance underwriting activities, and in various other activities that the board might not deem to be financial in nature should be required to choose between continuing these activities or acquiring an uninsured State chartered bank.

While H.R. 1062 permits a bank holding company to own a full service securities subsidiary, and certain securities firms can own insured banks, it also provides a number of limitations on the ability of a securities firm to own an insured bank which we believe should be removed. A more competitive and fair approach is to permit securities firms to continue engaging in nonfinancial activities without restriction and to impose firewalls to prevent inappropriate lending and similar arrangements with affiliated banks.

We believe that securities activities by any entity, be it a broker-dealer or a bank, raise concerns as to the adequate protection of investors and the operation of fair and efficient securities markets.

While the act generally would provide for functional regulation, there are notable exceptions which we have discussed at greater length in our written statement.

We commend you, Mr. Chairman, and this committee for your efforts to comprehensively reform the financial services industry, and we support those efforts. We look forward to assisting you, Mr. Chairman, the members of your committee and your staffs with crafting a bill that truly reforms the regulation of financial service to provide competition without Federal subsidies, a two-way street for entrance into banking and securities activities, and functional regulation.

Such a bill would provide for equal competitive opportunities for all financial services providers which would ultimately benefit all consumers of financial services.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Marc Lackritz can be found in the appendix.]

Chairman LEACH. Thank you for that less than ringing endorsement of the approach on the table, but we appreciate your views on it, Marc.

Mr. Fink.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman.

I am Matthew Fink, President of the Investment Company Institute, which is the mutual fund trade association.

Our mutual fund members include funds advised by all types of firms, including investment counselling firms, broker-dealers, investment bankers, industrial firms and commercial banks. Our members include some 1,200 mutual funds that are advised by commercial banks. Our mutual fund members have assets of over $2.2 trillion accounting for approximately 95 percent of total mutual fund assets, and our funds have 38 million shareholders throughout the country.

Bank entry into the mutual fund business in recent years has been a positive development for the banking industry, the mutual fund industry, and the public. But bank participation in the mutual fund business, which has taken place in the complete absence of authorizing legislation, requires that Congress address a number of outstanding issues. These include: The need to remove unnecessary barriers to bank mutual fund activities; the need to clarify the responsibilities of the various regulators; the need to modernize the Investment Company Act to add investor protection provisions tailored for mutual funds advised by banks; and, the need to repeal outmoded exemptions for banks under the Federal Securities Laws.

While H.R. 1062 positively addresses these concerns, it does not address the important additional need to establish a two-way street for securities firms that wish to enter commercial banking, nor does it rationalize the role of the Federal Reserve Board vis-a-vis the nonbanking activities of such firms. It is our very strong view that you need to amend the Bank Holding Company Act for these purposes. I will discuss each of these points in turn.

First, as part of a broader bill that would accomplish these purposes, we support expansion of banks mutual fund powers. Today, banks have most of those powers, and the remaining restrictions under the Glass-Steagall Act are increasingly perceived as statutory vestiges that serve no useful purpose today. In that connection, we particularly support the bill's provisions that would give bank affiliates the power to sponsor and underwrite mutual funds, and that would remove barriers to interlocking directors.

Second, we strongly support the provisions in the bill that would implement an approach of functional regulation by affirming the Securities and Exchange Commission's primary authority over bank mutual fund activities. This would reduce regulatory inconsistencies, duplication by different regulators and unnecessary burdens on banks.

Third, we generally support the proposed amendments to the Investment Company Act to protect investors in bank-sponsored mutual funds. The Investment Company Act already contains a number of provisions specifically directed toward the conflicts that can exist when a securities firm advises and sponsors a mutual fund. But when those provisions were enacted in 1940, Congress believed that the Glass-Steagall Act prohibited banks from advising and sponsoring mutual funds. Therefore, the Investment Company Act, written in 1940, does not address the potential abuses that can arise when a bank performs these functions.

We think the bill is admirable in that it would amend the Act by adding investor protection provisions that can address bank conflicts, such as when a bank serves as a custodian for a fund it is managing, or when a bank lends money to a fund it is managing. Mutual fund shareholders must be protected against these conflicts, just as they are already protected against similar conflicts that can arise when a securities firm sponsors a mutual fund. Legislation should not, however, impose unnecessary restrictions on banks and, therefore, we recommend some technical changes in those Investment Company Act provisions, basically by replacing the prohibitions proscribed in the bill with grants of authority for the SEC rulemaking.

Fourth, we support the provisions in the bill that would repeal outdated exemptions for banks under the securities laws. For example, the Investment Advisors Act, which also was passed in 1940, requires advisors to all mutual funds to register with the SEC as investment advisors, but it exempts banks because it wasn't thought in 1940 that banks could be in the business. The bill wisely eliminates this gap.

The bill does all of those good things and we commend it and support those four areas very strongly. But one objective of financial service reform that H.R. 1062 would not achieve is that of competitive equality between banks and securities firms. H.R. 1062's approach would create a clear competitive inequity. Under the bill all banks could enter the securities business, but many of the nation's leading securities firms could not enter the banking business.

For example, many securities firms are affiliated with insurance companies and under the bill such a firm could not acquire an insured bank unless it divested itself of its insurance affiliate.

Related to that as a practical matter, the approach taken in the bill is likely to discourage even those securities firms who are only in securities activities from becoming affiliated with banks. That is because any such securities firm under the bill would be forced to become a financial services holding company subject to regulation by the Federal Reserve Board. Since securities firms are already extensively regulated by the Securities and Exchange Commission, the prospect of duplicative and inconsistent regulation, I predict, will be a strong deterrent to any securities firm acquiring a bank.

We respectfully urge that the bill be revised to address these concerns, and we commend the approach taken in H.R. 814, the Depository Institution Affiliation Act. Under that bill, a financial services holding company would be allowed to own banks, securities firms, insurance companies, real estate companies, or any other type of company. Each subsidiary would be functionally regulated,

and the holding company itself would be under the jurisdiction of a committee of the various Federal regulatory agencies.

We would be pleased to work with the committee on this approach or any other alternative that would address this very serious need to achieve competitive equality.

Mr. Chairman, I can't emphasize too strongly that reform of the financial services system is not simply an issue of expanding bank powers. The issue affects all providers of financial services: Broker-dealers; investment counsellors; investment advisors; investment bankers; insurance companies; and others. It affects all American consumers of financial products, and the economy as a whole.

I am sorry if I didn't give you any better hope than Mr. Lackritz did, but I thank you, and I would be happy to answer any questions.

Thank you.

[The prepared statement of Mr. Matthew Fink can be found in the appendix.]

Chairman LEACH. Well, I appreciate what you are saying and let me apologize to Congressman Bentsen who has just arrived, but we have just had second bells on a vote, and so I think rather than starting Mr. Baptista's testimony at this point, I think it would be better to recess for 10 minutes.

I would just make one observation, this bill is not designed only to expand bank powers. It is no accident that Mr. Lackritz's organization has some membership who support this bill. This, after all, has been endorsed by Goldman Sachs as well as J.P. Morgan. This is a financial services approach in which people are trying to balance all interests. Whether you agree or disagree with how those interests are being balanced is obviously a fair question. I expect disagreement, but any other approach has disagreements, too.

Mr. LACKRITZ. I realize that.

Chairman LEACH. We will recess for 10 minutes.

[Recess.]

Chairman LEACH. The committee will reconvene.

Mr. Fink, we had finished.

Mr. FINK. Thank you, sir.

Chairman LEACH. You had finished entirely?

Mr. FINK. Yes, sir.

Chairman LEACH. Mr. Baker—excuse me, Mr. Baptista. [Laughter.]

STATEMENT OF SAMUEL J. BAPTISTA, PRESIDENT, FINANCIAL SERVICES COUNCIL

Mr. BAPTISTA. Thank you, Mr. Chairman.

I appreciate the opportunity to present the views of the Financial Services Council on the need for financial reform. Mr. Chairman, we commend your leadership in placing this debate back at the forefront, for there is no greater or more pressing issue facing our nation's financial services industry than that which is being advanced by you and members of this committee.

The ability of American financial service providers to continue to be innovative and competitive in a market rapidly changing through new applications of technology and telecommunications is constrained by antiquated laws and regulations that present bar-

riers to affiliation. A safe, sound and internationally competitive financial services industry is essential to the nation's economic vitality and the financial well-being of our citizens. Financial markets, both domestic and international, have changed dramatically since 1933 when the Glass-Steagall Act was passed, and they have continued to change every bit as much since the passage of the Bank Holding Company Act in 1956.

Today's marketplace no longer recognizes a distinct role for a commercial bank, an investment bank or an insurance company. It instead recognizes the role of a financial intermediary. While our static legal structure tries to compartmentalize the financial services industry, the market does not. The walls are porous enough to allow the competitors of banking organizations to effectively penetrate markets which had historically been the province of banking and to allow banks to penetrate markets traditionally reserved for other providers, but though they are diversifying to the extent legally possible, none can truly follow their customers and compete effectively because each has limitations on its ability to provide a full menu of services.

Because of these market developments, we no longer have the luxury of dealing with reform one industry segment at a time. The Glass-Steagall Act and the Bank Holding Company Act need to be dismantled in tandem.

Mr. Chairman, the legislation pending before this committee recognizes and seeks to address the artificial barriers to competition and efficiency by updating our financial laws to more accurately reflect the marketplace. Your revised bill, H.R. 1062, focuses primarily on the banking and securities side of the equation. The Administration's proposal, or at least outline, would appear to allow for affiliations of banking, securities, and insurance firms. Representative Baker's bill, H.R. 814, addresses in a more comprehensive manner the competitive interplay of the entire financial services industry.

Mr. Chairman, H.R. 1062 is a significant step forward from H.R. 18 in its recognition of a broader financial landscape, but while we are particularly encouraged to see that it addresses some of the more onerous provisions of the Bank Holding Company Act that stem from the Fed's cumbersome application process, the Council continues to believe that the bill's limited approach to affiliations remains problematic.

As the financial services industry moves further into technological manufacturing and delivery of products, the line between what is financial and what is not becomes blurred. For example, it seems to us to make no sense at all to exclude insurance from being financial in nature when the market clearly dictates that it is. Under this construct, the Federal Reserve Board would be precluded from making the determination that companies like Travellers, Aetna, AIG, Prudential, Providian, USAA and Kemper fit within the revised statute. These are not just insurance companies, they are, in the eyes of the marketplace, the very essence of a financial services holding company. To foreclose their inclusion within a new statutory framework for financial services holding companies is counter-intuitive to the realities of the marketplace.

Moreover, by building on the existing Bank Holding Company Act structure, its restrictive holding company regulation is perpetuated. Rather than concentrating and focusing solely on the supervision and protection of the insured depository institution, regulatory attention will continue to be focused on the activities of the holding company in a bank-like manner. The Council believes that regulation should be focused from the bank outward versus the holding company down regulatory approach of the Bank Holding Company Act.

In contrast to H.R. 1062's continued reliance on the more restrictive Bank Holding Company model, the bill introduced by Mr. Baker, H.R. 814, is fundamentally more market-oriented, recognizing the competitive needs of the entire financial services industry. It would permit any company, including a commercial company, to affiliate with a bank or thrift, provided it becomes a financial services holding company and complies with the act's many regulatory and supervisory provisions. The Council fully supports the structure contemplated by H.R. 814.

Mr. Chairman, if I may, I would now like to take a few minutes to address a principal concern you have regarding banking and commerce. Clearly one of the primary philosophical distinctions between your approach and that of Mr. Baker is the allowance for affiliations between financial and commercial firms. Under the Baker bill, commercial firms can affiliate with banks and banks can affiliate with commercial firms under the auspices of a financial services holding company.

Affiliations between commercial firms and banks is neither a new nor a radical concept in our country. In a 1987 study, the FDIC noted, and I quote, "There has never been a complete separation of finance and commerce in the history of American banking. Banking and commerce have been mixed in the United States since our country's birth." Today most of the commercial firms that own limited purpose banks or thrifts do so because they have chosen to diversify into financial services, and the affiliation allows them to more fully serve their customers' needs.

Furthermore, the law has always permitted individuals to own a controlling interest in both a bank and a commercial firm, and throughout American history individuals have simultaneously owned and managed both a bank and a commercial firm. Thus, an individual on Main Street can own the only bank in town as well as the only insurance agency, real estate agency, car dealership, hardware store, and so forth. Yet publicly traded companies may be prohibited from having such affiliations simply because of their corporate structure. Surely if restrictions on affiliations with commercial banks are appropriate for publicly traded companies subject to the rigors of market regulation and the rating agencies, they should apply as well to individuals whose activities and financial conditions are subject to far less scrutiny.

Considerable attention has been given to the perceived threats associated with commercial firms entering the banking industry. If the real issue is concentration of financial resources, it would be simple enough for Congress to prohibit the merger of two giants, one from the commercial world and one from the banking world. If the issue is the protection of the depository institution from deal-

ings with commercial parent, then erect appropriate firewalls to prohibit such transactions.

In summary, the taxpayers, your constituents, our members' customers, would benefit from the development of a truly comprehensive financial services holding company structure. The benefits of competition, the market constraints on prices and incentives for efficiency and innovation are widely recognized. Only through comprehensive structural reform can we achieve these vital public policy goals.

Thank you.

[The prepared statement of Mr. Samuel Baptista can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Baptista.

Mr. Tassey.

STATEMENT OF JEFFREY A. TASSEY, SENIOR VICE PRESIDENT OF GOVERNMENT AFFAIRS, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. TASSEY. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, my name is Jeff Tassey and I am presenting this testimony on behalf of the American Financial Services Association, AFSA. We are the trade association for a wide variety of nontraditional market-funded providers of financial services to consumers and small businesses.

The American Financial Services appreciates and acknowledges the reforms made by H.R. 1062. It is a full step forward, and we understand that a great many political and jurisdictional considerations were involved in the policy choices that were made.

As we read the bill, the primary tier of benefits would flow to larger wholesale banks and investment banks. These institutions would presumably enjoy greater economies of scale and a strengthened competitive position in global capital markets. The bill would also benefit institutions without commercial and substantial insurance affiliations who wish to become a financial services holding company. While the bill retains the Federal Reserve as the holding company regulator, the bill's intent is to provide a notice procedure as opposed to the current application procedure. The bill makes substantial steps in that direction, although some subtle issues may remain which we hope to address with the committee as the process continues.

The investment bank holding company established in the bill, while not presently of direct interest to most of our members, provides a useful approach for dealing with deposit insurance concerns for certain activities while providing some other benefits the present banking system confers upon its member banks. Where deposit insurance is not a factor, though, there is no reason to restrict affiliations. We urge the committee to explore what other kinds of uninsured institutions could be established that might meet various needs in our financial markets.

The affiliation issue is one of our primary concerns with H.R. 1062. As indicated at the beginning of our written testimony, AFSA represents an extremely diverse group of lenders, primarily market-funded, and accordingly subject to intense scrutiny and regulation by the markets.

A great many of these entities have a wide range of functionally constrained affiliations with some type of federally insured institution. There has never been any evidence that any of these entities pose any systemic or deposit insurance risk as they go about their business of providing between 10 and 15 percent of all consumer credit.

At the very least, a true financial services holding company should include insurance. It is difficult to argue that insurance is not financial in nature, or incidental to such financial activities. The Federal Reserve has in the past found such businesses as armored car services and stock quotation services to be incidents of banking. The Export Trading Company Act of 1982 authorized bank holding companies to establish subsidiaries engaged in the business of trading goods and services.

Beyond insurance, AFSA strongly supports the ability of commercial firms to own or otherwise affiliate with such a holding company. The prohibition on banking and commerce has always been shot through with exceptions. Thousands of individuals own banks who also own many and varied commercial interests none of which are subject to the same holding company affiliation restrictions and oversight as banks owned by corporate entities.

If it is harmful for banks and commercial entities owned in the corporate form to affiliate, then the same restriction should apply to the thousands of wealthy individuals who freely mix banking and commercial enterprises.

The primary argument postulated against banking and commerce is that such a holding company form would result in large concentration of economic resources. Such concentrations are far more likely to occur in small towns where, as I just described, there is only one bank owned by an individual who also owns other major economic units, such as the local independent insurance agency, car dealer, feed store, and so forth.

Economic concentration, particularly in today's global market, is not just size but size in relation to the market in which the entity operates. A very large institution operating nationally and internationally is subject to competition at every size level from the smallest independent bank to the largest Japanese bank.

In terms of risk to the bank and insurance fund from such a diversified structure, the experience with life insurance holding company is instructive as discussed on page 7 of our written statement. Congressman Baker's bill, H.R. 814, draws somewhat on that model.

In terms of the limited relief provided by H.R. 1062 from the growth cap and affiliate transactions restrictions contained in the Competitive Equality Banking Act of 1987, AFSA appreciates the Chairman's initiative on this issue. Especially in light of the affiliation restrictions in the financial services holding company established by H.R. 1062 and the total lack of affiliation restrictions on individuals, as I have just discussed, AFSA strongly believes that the asset growth limitation, as well as other CEBA restrictions, should be eliminated for all grandfathered CEBA limited purpose banks. This is especially so if the committee does not choose to expand affiliations in H.R. 1062.

In addition to AFSA's affiliation concerns and the limitations on CEBA relief, the more general concern that we have is that the bill does not do enough to bring market discipline to the insured portion of the industry nor does it address the overriding issue of excessive deposit insurance. AFSA feels that Congressman Baker's bill, H.R. 814, does more to increase market discipline while allowing greater affiliations, although it does not directly deal with the issue of deposit insurance either.

In the 1980's, numerous banks and thrifts continued to operate even though their market ratings were well below investment grade. In contrast, if the markets lose confidence in a market-funded lender, it may no longer have the ability to fund its activities and to grow. It must shrink and ultimately may be forced to close.

Second, the market typically requires that the market-funded lenders hold more capital relative to assets than banks. Attached after page 15 of our written statement is a recently released chart showing that a representative sampling of financial companies had average equity to assets almost double that of a representative sampling of banks.

As discussed in our written testimony, it is the sensitivity to the financial condition of both the commercial parent and financial subsidiary combined with the ability of the market to act quickly without discretion that makes market regulators so effective and gives lie to so many of the arguments against affiliations with insured institutions.

In the structure proposed in H.R. 814 with separately capitalized affiliates, most of whom are market-regulated, it is difficult to see the risks to the insured institution, especially when combined with the bill's capital bear down provisions. H.R. 1062 takes a full step forward in modernizing our financial system and should be applauded. At the present time, AFSA feels that H.R. 814 provides a better basis for placing all issues on the table and moving forward with comprehensive modernization.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Jeffrey Tassey can be found in the appendix.]

Chairman LEACH. Thank you all for very thoughtful testimony. I am very appreciative.

Let me say, last week the Deputy Secretary of the Treasury, Frank Newman, listed a number of reasons for maintaining barriers between commerce and banking. He warned of financial conflicts of interests, including the making of loans against a bank's better judgment, possibly money-laundering, and industrial espionage.

How would each of you respond to those concerns? Are they vacuous, are they real, or can they be dealt with in other frameworks? Marc?

Mr. LACKRITZ. Mr. Chairman, I think the concerns that the Deputy Treasury Secretary raised obviously are serious concerns from a standpoint of public policy. From the standpoint of the securities industry, we have never had a clear delineation that commercial firms cannot be in the securities business, and the securities business and the capital markets business is obviously very financial

in nature and has a lot more risks in many respects than banking does. As a result, a lot of the securities firms have been owned by commercial firms and have, in themselves, owned commercial firms, and now we feel that securities firms want the opportunity to get into banking. So we don't see that there should be any kind of theological barrier in terms of separating financial activities and commerce.

Chairman LEACH. Mr. Fink.

Mr. FINK. I would echo Mr. Lackritz. Many mutual fund companies, as part of the securities industry, have commercial affiliates or parents. Sears, who used to own Dean Witter. Prudential owns Bache. There is probably a list of a hundred. The same potential for abuses that Secretary Newman mentioned, I guess, could come up. But I am unaware of any case where there was an allegation that a commercial affiliate of a securities firm committed those abuses, so I think there is a logical inconsistency here.

Chairman LEACH. But did they have access to insured deposits?

Mr. FINK. No, but the same danger exists. They could pillage the securities affiliate. Insured deposits may be a step further. That hasn't happened because you have had strong firewalls and a strong regulator, the SEC. I think those are the keys.

I might say, I saw in today's *American Banker* that Mr. Newman is wavering a bit. The original bill had a 5 percent basket, but today's *American Banker* reports that Secretary Newman is at least open to consideration of raising that basket.

So I don't think he sees it as a black-and-white situation, and I don't think that, given the history of the securities industry and mutual fund industry that either would support a lack of accommodation for commercial affiliation.

Chairman LEACH. Well, I appreciate that.

Let me just comment on the basket. Perhaps the worst law of the 1970's, in my judgment—excuse me, 1980's, was one passed in the State of California that allowed federally insured savings and loans to use up to 10 percent of their assets for direct investments, which is precisely what is being called for here.

Now in this case many of these institutions had zero capital. But the idea that you can use federally insured deposits to make venture capital or direct investments is something that raises grave doubts in a competitive equity sense, unless you have adequate insured deposits covering banking functions in general. I would raise certain concerns in that particular arena.

Anyway, Mr. Baptista?

Mr. BAPTISTA. Mr. Chairman, I don't think any of the bills would call for and I don't think it would be proper to use direct investments of insured deposits for those types of activities.

Chairman LEACH. I think that is what the Treasury has called for.

Mr. BAPTISTA. I believe they were talking about a basket within the holding company that would allow up to 5 percent of the holding company's assets to be nonfinancial, not to have 5 percent of the bank's investments.

Chairman LEACH. I think if you are looking at the Treasury proposal, you are talking about a sub of a bank and 5 percent of the assets of the bank. You are not talking about the capital of a bank,

you are talking about the assets of a bank within a subsidiary, and that is what I would, frankly, put some alarm bells about.

Mr. BAPTISTA. To the degree that you are talking about the activities being conducted in an operating sub of the bank, and as it relates to commercial activities there, I think you would have a point. I was particularly referring to the type of approach in the Baker bill and in the D'Amato bill.

Chairman LEACH. I don't mean to raise differences because the Treasury proposal is coming very close to my bill. So I want to thank Secretary Newman who is one of the really thoughtful people in government, so I don't want to carve out too many distinctions with him because he is, both logically and in decency, a superb individual. But I do raise concerns on the subsidiary approach.

Mr. BAPTISTA. I think we also lose sight of the Change in Bank Control Act. There are safeguards in place that look at the managerial and capital standards of those companies whether they are individuals, bank holding companies, or anyone who acquires a commercial bank, and I think all of these provisions would continue to apply, and rightfully so, to the Change in Bank Control Act.

Chairman LEACH. Fair enough.

Just briefly, Mr. Tassey, do you want to respond?

Mr. TASSEY. Sure. I think most of the specific examples Mr. Newman raised were related to banks that made commercial loans. I represent more consumer lenders and don't want to get too far outside of the area of expertise. I think, again, the life insurance holding company model, where you have a mixing of mutual funds, insurance companies and securities firms, those offer some instructive experience on how to deal with these kinds of conflicts. There is a State insurance fund there. The difference is, the State governments tend not to stand behind it as much as the Federal Government does, so there is some more failure pressure on it, but I think you have all the same temptations in that kind of model.

Chairman LEACH. I appreciate that, and I would only raise the non-American model. I think it is very interesting to see how the Germans are retrenching from their prior position, and most profoundly, if you look at the failure of the Spanish bank, Banesto. Banesto's failure was heavily related to the bank taking on direct ownership of a series of companies that it had no idea how to operate. There is no great history, when you talk about histories in this country, there is no great history in the United States of America of bankers running well nonbanking activities. It is a pretty barren sheet, and I just raise that there is also not a good social good implied.

Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I did not hear the first three speakers today, so I am going to reserve my right to ask questions until later. I have a number, but I want to hear their responses to the other people first as background.

Chairman LEACH. Fair enough.

Before turning, Doug, I apologize, I didn't know there was a member of the minority present. I am sorry. I missed Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I am not used to being allowed to ask questions this early in the process, but I will do my best. [Laughter.]

Mr. BENTSEN. Let me ask a couple of questions because I, unfortunately, was caught outside with some meetings and didn't get to hear all the testimony. Let me ask you this, from the standpoint of, if we move to a system of a two-way street with banks and securities firms being able to merge, would you see, and particularly from the mutual fund standpoint, do you think we would see a movement of monies that are in mutual fund accounts into insured deposit accounts?

I know Merrill Lynch already has a bank, but say that Merrill Lynch is now able to merge and really have a joint operating company with XYZ Bank, do you think that people who are now more and more, I think, beginning to treat mutual fund accounts as deposit accounts, move to an insured deposit?

Mr. FINK. I don't think it would move it one way or the other. The banks have almost 90 percent of mutual fund powers now. Mellon acquired Dreyfus which is, I think, a merger of the sixth largest mutual fund company and one of the country's largest banks. To my knowledge, there has been no movement of Dreyfus fund accounts into Mellon deposits. You can have cross-selling, but I don't think you get a movement from product to product.

Mr. BENTSEN. OK.

Mr. LACKRITZ. Could I just add, if you look at the numbers from overall financial assets, there has been a diminution of the assets held in commercial banks and increase in the level of mutual fund assets. So that if you look back to 15 or 20 years ago, commercial banks had I think it was around 55 percent of all financial assets. That has now declined to around 31 percent or 32 percent. In fact, mutual funds have a significantly greater proportion now of all those financial assets.

So I think that is a result more of the interest rates and the yield curve and the ability to move funds rather than the organizational structure.

Mr. BENTSEN. Let me ask a question that I brought up this morning and we talked about last week as well that relates to regulation, and of all the bills, the Chairman's bill and Mr. Baker's bill and the D'Amato bill have various regulatory mechanisms in them, if you will, and there has been some question.

It seems to me there is some question that while I wouldn't advocate designing the regulatory regime before we design what the final bill is going to be, do you think there is a need that we have some mechanism that we come back to at some point and retrofit the regulatory regime to a new financial services law, because I am concerned that right now we may end up with a cumbersome regulatory structure if, in fact, we are able to put through a new financial services law?

Mr. BAPTISTA. There is a provision in Mr. Baker's bill that creates the National Financial Services Oversight Committee. One of the functions, one of the charges of that committee, is to explore just what you are talking about. After gaining experience with functional regulation, what types of changes in the regulatory apparatus would be appropriate.

That needs to be an ongoing discussion. We continue to believe that the focus should be on the affiliate and the regulation of the affiliate, and with additional safeguards, if necessary, around the

depository institution, but I think that that is something that Congress should be studying over time as these changes take hold, and I don't think that it should be a rigid structure.

Mr. BENTSEN. Quickly, let me ask a final question, and that relates to, if we have a new merger in a two-way street, maybe you go through this with the Baker bill and Secretary Rubin thought that this would be true under the Administration's position, but if you have one of these new banks that has a merchant banking arm, an investment banking arm, and a commercial banking arm, and the institution gets involved in a leveraged buyout of a company. Do you believe that it would be a situation where the investment bank would be handling the leveraged buyout and raising the debt through the securities market, the merchant bank would be purchasing the shares of the company up to the percentage that is allowed based upon whose bill it is as part of a banking activity, and then that the commercial bank would be able to make the long-term portion of the debt, and do you think that is good policy in doing that?

Mr. LACKRITZ. Let me just take a shot at that. Those are some of the concerns. The issue that you raised is a fact pattern that gave rise to some of the concerns that gave rise to Glass-Steagall in the first place. Given what has happened with the Federal Deposit Insurance, and the possibility of Federal Deposit Insurance being utilized inappropriately, as Chairman Leach mentioned earlier, to get into risky activities, that is serious. The concern that you are raising is a very serious one, which is why we support the stronger firewalls in the legislation, and ensuring, if you will, that you cannot have federally insured deposits being used for risky activities, whether it is investing the California savings and loan situation or other circumstances that were raised before.

Mr. BENTSEN. Mr. Chairman, if you might, very quickly, and I agree with that. I guess the concern that I have, even with as with the firewalls, is there adequate protection that somehow, if you had a transaction that goes bad, that the losses run upstream through the investment banking side and the merchant banking side into the commercial banking side beyond what reserves are there that it could affect insured deposits. Is that something we should be overly concerned about?

Mr. LACKRITZ. Yes, I think it is very important concern. But, on the other hand, that is why capital is so critical, and that is one of the reasons that, in terms of capital the regulatory structure has to ensure that capital is adequate and that the monitor of transactions between and among affiliates in that structure, that would be the proper and appropriate role for a regulator in that situation.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Gentlemen, thank you very much for your testimony. I have been here for it all, but I am still not sure I have sorted through it all.

Mr. Tassey, in your testimony for the AFSA, you expressed concern, I believe, about the Federal Reserve being a bank regulator as opposed to another of the existing financial service regulators.

What is the basis of your concern or AFSA's concern or complaint about the Fed as a regulator?

Mr. TASSEY. In the written testimony, I believe I said that Chairman Leach's bill made numerous changes to the holding company notification and application process which were highly beneficial. The Federal Reserve in the past has been primarily a bank regulator and it has the culture of a bank regulator, which is not, you know, necessarily bad, but it has had difficulty in adapting to other kinds of institutions owning limited purpose banks, such as my members that own banks that are covered by the comprehensive Banking Equality Act.

I think Jim Robinson, when he testified before the Capital Market Subcommittee the other day, said that the Fed needs to become a financial services regulator as opposed to just a banking regulator if we are going to move forward. It is a subjective comment. There is not anything specific in Mr. Leach's bill that says that those institutions shall be regulated differently than any others. It is just based on experience.

Mr. BEREUTER. It is not because of your view that there is a disproportionate concentration on safety and soundness in the Fed, that would not be the reason?

Mr. TASSEY. No, sir. We would expect them to be concerned with the payment system and other safety and soundness issues.

Mr. BEREUTER. Thank you.

Mr. Lackritz, last week the Treasury Department and the Federal Reserve in their testimony indicated that small- and medium-sized firms would benefit most from Glass-Steagall reform because those firms are not being adequately served by investment banks. Does the SIA agree with the assessment? If the securities markets are so competitive as we are hearing, why are these firms not being provided securities underwriting services, or do you disagree with the premise?

Mr. LACKRITZ. You know, with all due respect to both those witnesses that may have asserted those points, I read their testimony and what they were relating, anecdotes what they had heard from small- and medium-sized banks around the country as to why they wanted to get into this market, because they felt that small firms were not getting adequate services. So I very much disagree with the premise.

If you look, I think, at the record of the last couple of years, in fact, from the standpoint of IPOs, initial public offerings, that the industry has brought forward, from the standpoint of margins, the margins have come way down in the business, and the competition is fairly high.

Now I think there are other reasons why we need to reform Glass-Steagall. I don't think that is one of them.

Mr. BEREUTER. To any of the witnesses who care to respond, Chairman Greenspan in his testimony argued that the holding company structure is the best framework for limiting the transference of Federal safety-net subsidies, the deposit insurance, the discount window and the access to the Fedwire, and so on. Do you agree?

Mr. BAPTISTA. As far as the Financial Services Council is concerned, we have always supported legislation that created all of

these affiliations through a holding company umbrella, and so we do think that that is appropriate.

We do have bank members, however, who would also support the notion of a universal bank, but that has not been a position that has ever been advocated by the Council directly. We have always supported a holding company model. We just disagree with the bank holding company framework that we have today.

Mr. TASSEY. We support the holding company model also. We have never asked for operating subsidiaries or any of those other devices. We think that separately capitalized affiliates in a holding company structure is the best way to go.

Mr. BEREUTER. We have the problem, of course, in the Congress and this committee, of allowing greater affiliations with other financial intermediaries at the same time containing what I think was referred to earlier as the moral hazards associated with federally backed insurance. So that is one of our dilemmas here, the basic one that we wrestle with. Any last minute thoughts about that subject?

Mr. BAPTISTA. Just one. In the last several Congresses, there have been several steps taken by this committee and by the Congress to address deposit insurance through FIRREA, FDICIA, and Depositor Preference Standards enacted in the last Congress that have put a number of backstops in place between the taxpayer and the insurance fund.

By dealing with activities outside of the bank, by making sure that there are appropriate safeguards, and ensuring that the regulators have the tools to monitor transactions, we think you can assure that insured deposits will not be misused. If there is a pattern of misuse of insured deposits, then the regulator should have divestiture authority and be able to force the holding company to jettison its depository affiliate.

Mr. BEREUTER. Thank you very much.

Chairman LEACH. Thank you, Mr. Bereuter.

Mr. BAKER. Thank you, Mr. Chairman. In my modest opinion, Mr. Chairman, this is the most insightful group of witnesses we have had so far. [Laughter.]

I thank you for your leadership.

Chairman LEACH. Without a doubt, you are one of the most insightful members.

Mr. BAKER. I continue to be impressed by your tremendous leadership.

Just a quick historical background before I ask. I am going to ask one question, and each of you who chooses to respond, please do, but I will be brief in this.

Just in looking at where capital markets generally have taken away from banks some of their more attractive corporate customers, where credit card issuers have taken away more of the consumer debt potential banks, banks seem to be operating in an environment where their potential customer base is greatly diminished, with heightened regulatory standards and an increased cost to do business. We have a couple of options if we want our economic system of banking to remain strong and grow, it is either to greatly minimize these regulatory constraints, or provide some re-

lief on regulatory constraints, and enhancing product diversity, things they can sell.

If we assume for the moment that enhancing the things they can sell and the business with whom they can enter into business with might be something we wish to explore, a logical concern expressed by many is that unknown events in a commercial affiliation might possibly lead to business losses which could flow through the holding company, and even with the highest, thickest and most obnoxious firewalls we can create, there might be a leak and somebody in the insured depository institution loses more than it should, and taxpayers are called to hold up those losses. That is a scenario which no one on this committee chooses to create the potential for.

How do we best stop that?

Just by way of historical data, Mr. Chairman, I happened to have struggled across a study done in 1986 by a fellow named Altman looking at commercial firm bankruptcy risk relative to that of financial institutions for the period of 1970 to 1985, and while the railroad industry and the oil and gas industry, both of which I have painful experience with, had higher bond default rates in dollar terms than the financial community; electronics, computers, communications, retailers, airlines, real estate construction, sea lines, and trucks and motor carriers all had either equal or lesser default rates than that of the financial community which was found to be at 8.8 percent.

The fact is that financial services in themselves are a typical business interest in the American economy and don't have a preponderance to succeed or fail to any greater extent than anyone else, but if we assume these commercial entities are, in themselves, unknown commodities that may engage in new risk that the financial services industry is not adequately prepared to regulate or insure against—let's assume everything goes wrong. We have a model where we are going to allow commercial ownership of a holding company in which there is an insured depository institution. What steps, if any, would each of you recommend that are not currently contemplated in any of the pieces of legislation that are before us to further limit risk, and I will give you some thought?

One is modification of deposit insurance for those who engage in new products and services; is that something that we ought to talk about?

Two, another suggestion which I found attractive is to allow the acquiring commercial entity to be that of a company which only has publicly traded stock, which means the SEC has looked at these people and determined that they are a commodity suitable for public consumption over-the-counter, or regulated stock exchanges, for example; or to allow commercial banks to have an affiliation as long as their own corporate debt is investment grade rated.

So that we could do one of several things, we could limit the corporate entities with whom you associate as being good corporate contributors in the mark-to-market sense, or we could hope for the best and simply limit deposit insurance guarantees by the taxpayer so that if something really bad happened, would not be on the hook as taxpayers from having made a bad business judgment.

Now the question is, is any of that necessary in your opinion? If something is necessary, what should we do?

Mr. Lackritz?

Mr. LACKRITZ. That is a difficult question, Congressman. The right way into it—I think the suggestions that you had or the possibilities that you had, I would have to evaluate those more. I am not sure. What we see in terms of the bills that are out there now, we think that a very attractive option is this wholesale uninsured bank who would be part of an investment banking holding company. So you would not have federally insured deposits at risk in any way, shape or fórm if a financial services institution opted to go for that form of organization.

Alternatively, if they want to use federally insured deposits, or at least half federally insured deposits in a holding company, then it seems to us that the firewalls have to be very secure so that they don't melt down in a crisis.

Mr. BAKER. Just on that point, if there are any deficiencies you can think of, or additional bricks we need to put in the wall, that is what we are asking for.

Mr. LACKRITZ. Well, specifically to that point, I think in the bill that is before us, in H.R. 1062, we are very concerned that the exceptions to the firewalls that are in there now are sufficiently large, and that the discretion that is granted to the Fed is sufficiently great as to make the firewalls more virtual firewalls rather than tough and secure firewalls.

So we would urge that those exceptions be narrowed and that the discretion to modify them that is granted to the Fed be circumscribed considerably in order to assure that those firewalls will hold up in times of stress.

The last point I would make, Congressman, in response to your question is that we also emphasize the need for functional regulation of each of the affiliates because while perhaps a commercial entity that might be part of a holding company structure is an unregulated industry and, in fact, nobody is going to have a very clear view as to what is going on in that commercial entity affiliate.

With respect to financial companies and with respect to securities firms or banking organizations, it is critical to have the regulator regulating the affiliates so that the securities regulator is regulating the securities affiliate, the appropriate banking regulator is regulating the banking company in that affiliate structure. I don't think there is ever going to be a situation where we could be 100 percent positive that the situation that you described wouldn't occur but, on the other hand, with the notion, at the holding company level, of somebody looking at the capital to assure that the capital is there to back up the insured deposits of the banking organization, and with functional regulation, and with the option of having an uninsured wholesale bank, we think that would ultimately minimize that risk.

Mr. BAKER. Mr. Chairman, I am way over my time. I will just ask the others to respond in writing unless they are constrained to make a comment.

Mr. BAPTISTA. I would be happy to comment.

Chairman LEACH. If you would like to comment, quickly please.

Mr. BAPTISTA. Just very quickly, I think the rating agencies are perhaps one of the toughest, fastest regulators out on the beat, bar none. If we are talking about publicly traded companies, and I

think we are, then clearly the rating agency is going to have the first signal of a problem in the corporate structure.

By relying on capital and enforcing, in all instances, the bank to be well capitalized, the absolute toughest and highest capital standards, and giving the regulator the authority to require divestiture if there is a problem, I think that works.

The problem with the wholesale bank is the affiliation with insured institutions. If you want to be a retail provider of financial services, if you want to issue just a simple VISA or Mastercard, because of the VISA or Mastercard bylaws, you have to be eligible for deposit insurance, so that presents a problem.

Chairman LEACH. Thank you.

Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. Good afternoon. I have a couple of questions. One of them has to do with capital standards, because I think this is one of the keys to the problem that we're having establishing capital standards that are sufficient to protect us against potential risk, to depositors and, in turn, taxpayers.

I saw in the testimony—Mr. Tassey of the AFSA notes that the median ratio of equity to assets for the largest bank holding companies is about 7.95 percent, while the median for the largest 20 publicly held finance companies is 11.9 percent. Do you think that the bank holding companies should have to meet that higher capital standard in order to engage in diversified transactions?

Mr. TASSEY. It's a complicated question. I mean, to some extent, with regulated institutions, what you're doing is substituting regulation for some of that capital. Those capital ratios that I refer to in my testimony are a judgment of the markets as to what kind of protection they want to see before they're going to invest in your short-term commercial paper.

While some banks or bank holding companies may be individually undercapitalized, you can argue that in the current regulatory environment others are overcapitalized in the sense that there is a constraint—you know, you're either a bank or you aren't. A bank never becomes something else. They never give up their charter and do anything else.

They may, given the activities that they can engage in and their regulatory structure and culture, maybe they have too much capital. Maybe that's why in past times a lot of bad loans have been made. If the capital doesn't have a good use, then you have too much capital. It could be even at 3 percent, 6 percent, whatever.

I don't make that point in my testimony to say that we're twice as good as banks because we have twice as much capital or we're twice as safe. I'm just trying to highlight the differences in regulation and the fact that capital is important, but, in and of itself, is not a determinant of competitiveness of what activities you should or shouldn't be engaged in.

Mr. LAZIO. Do you think the market is a good barometer?

Mr. TASSEY. We have a lot of experience in our industry where you have a commercial parent owning either a non-bank financial subsidiary or, in some cases, an insured subsidiary, as well. What we find is that the commercial paper markets and the rating agencies move very swiftly. Commercial paper is short-term maturity,

270 days, and there have been almost no failures of rated commercial paper. There have been none for a finance company.

Basically, there's a good exit mechanism there, there's a good early warning system, and the ownership of an insured institution tends to affect the parent more adversely than you would think. Even though there is deposit insurance, I think the rating agencies in the commercial paper markets realize if the insured institution gets in trouble, it's a black hole for the commercial affiliates because the regulators are going to be looking or the markets are going to be looking to the parent to prop up the credit rating of that subsidiary.

It's not a perfect model for insured institutions. There are a lot of differences. But if some of that market discipline could be injected into insured institutions and some of the excessive deposit insurance squeezed out, as appropriate, then it might make these policy decisions a little easier.

Mr. LAZIO. Let me ask Mr. Baptista. I noticed in your testimony, and I apologize for not being able to hear it, discussed in Mr. Baker's proposal, which you favor, that there is a mechanism for a bank to lend to a non-bank subsidiary up to 20 percent, I think, of its—am I correct in that? In its capital.

Tell me, if you can, what would allow us to ensure that we didn't get to the point in a subsidiary situation where there is insolvency. We wouldn't have to go to ground zero before we were able to react to that potential loss of capital on the part of the bank.

Mr. BAPTISTA. I think in the first sense, it's the bank lending to an affiliate. I was describing the provisions of 23A and 23B of the Federal Reserve Act that applied to all transactions between banks and their affiliates, which we believe are the proper standards and we think there perhaps should be some flexibility for the regulator, depending on costs, to make those adjustments.

We have always supported what is referred to as the bear-down provision—it's the capital enforcement standards in the Baker bill—that require the regulator to step in at the first sign of any capital deficiency. All depository institutions controlled by financial services holding companies in this proposal would be required to keep their banks well capitalized, the highest possible standards established under FDICIA.

Mr. LAZIO. But that might not be 40 percent.

Mr. BAPTISTA. We're talking about roughly 10 percent capital in many instances. The notion is that the minute that the bank would fall below that minimum capital level, the highest capital level, the regulator would have to step in. There would be no option. It would have to step in, work out an arrangement within 30 days with the parent company to get back to well capitalized. Any failure to work at that agreement would require an automatic divestiture of the institution.

Our notion there being to step in at such an early stage, you're not waiting till—I think the standards now, if I'm correct, are 1 or 2 percent capital before there's a forced divestiture as a result of FDICIA. So we're talking a much, much more early warning system.

Mr. LAZIO. My time is up. Thank you, Mr. Chairman.

Chairman LEACH. Would you care for more time, Mr. Lazio?

Mr. LAZIO. I had one additional question, if I can.

Chairman LEACH. Yes, please. Go right ahead.

Mr. LAZIO. Thank you. I take it everybody would be fans of functional regulation on the panel. What's the aggregate opinion of the interagency model that both the Administration and I think Mr. Baker favor in terms of regulation? For the people—for the banks that have less—for the holding companies that have less than 50 percent of their money in banks or thrifts.

Mr. LACKRITZ. The question you raise I think is who should oversee or who should regulate the holding company, whether it's a financial services holding company or an investment banking holding company or a different kind of financial holding company. That's a tough question, I think, because it's important from the standpoint of overall viewing the system, that somebody, in fact, has a view as to how that holding company's capital is—to assure that the holding company capital is adequate to support an insured depository institution, for example. So that it's a source of strength for the insured depository institution.

And on the other hand it's important, from the overall standpoint, to assure that transactions between and among affiliates of the holding company are appropriate and not done at less than an arm's-length basis. So from that standpoint, how you pick—you have a couple of different models there where you could pick either the Fed to do all that for every financial services holding company or you could pick the primary—the regulator, the primary business in that financial services holding company, or you could create some interagency council of some kind to oversee it and come up with the right model.

I can tell you that from the SIA's perspective, we don't have a clear perspective or consensus on that yet among our members. As you know, the SIA represents a fairly competitive, diverse and relatively fractious industry. So we haven't quite reached a consensus on that.

Mr. LAZIO. You know better than I do.

Mr. FINK. Mr. Lazio, I might—I certainly—in the case where the bank is not predominant, at least, I certainly think it would be a mistake to have the Federal Reserve Board on top and the committee is much better. Let's give you a couple of reasons.

I was looking at Chairman Greenspan's testimony last week. He warned that even the Board was concerned that if the umbrella agency is a banking agency, the market will believe that "the government is responsible for the operations of the entire holding company as it is for banks. This subtle transference of the appearance of safety net support to financial affiliates of banks creates a moral hazard."

If you pass this legislation and a large securities firm or mutual fund company acquires a tiny bank, I don't think it makes any sense to have the Federal Reserve Board as the czar of the holding company. It will create this moral hazard.

Second, we've seen in banking regulation already, because the banking regulators are concerned with the safety and soundness, when the FDIC was the first banking agency to allow subs of State non-member banks to do securities underwriting in mutual funds, they imposed safety and soundness constraints on the types

of securities and mutual funds, those securities affiliates could underwrite.

The bank safety and soundness principle started to permeate non-banking activities. I think that's very bad for the securities industry and very bad for the economy. So I think at least where the bank is not the predominant entity in the holding company, the committee structure—as Mr. Lackritz said, there are many alternatives, but the committee structure would certainly be preferable to having the Federal Reserve Board as the czar.

Mr. LAZIO. I thank the Chairman for his patience.

Chairman LEACH. Thank you. Before turning to Mrs. Roukema, I want to clarify a circumstance. The quote you read is a valid quotation, but I think it would be misleading to suggest that even though he reflected a concern, the Chairman of the Federal Reserve Board is certainly in favor of Fed regulation in this circumstance. So I don't want anybody to misunderstand that situation.

Mr. LAZIO. I didn't mean to——

Chairman LEACH. On the second point, let me be very clear. As you look at the panoply of alternatives, this Congress has two choices on the critical issue of defining, A, regulation; B, what is a financial activity. Congress can decide that an independent regulator make these definitions or that a politicized board make them. The choice is between politics and independence.

I will tell you when it comes down to that choice, it is darn difficult, despite all the reservations one might have about the Fed, not to opt for the Fed. Darn difficult. And I think that's going to be one of the critical decisions this committee is going to have to make. Mrs. Roukema.

Mrs. ROUKEMA. Well, I couldn't agree with you more, Mr. Chairman, and I don't know what Mr. Fink wanted to respond. But I totally agree with the Chairman with what he has just stated. And I don't even know if I have a question now. Let's see. I'll talk for a minute or so and see if I come up with a question.

But I want to tell you that from what I've heard, and I've only been able to read through Mr. Lackritz' testimony, not everyone's testimony, but from what I've heard, you've all given the same kind of allegiance to safety and soundness and firewalls, but nobody has gone on to have any agreement as to what constitutes safety and soundness and firewalls.

I've got to tell Mr. Baptista that I have a fundamental opposition to the idea of entering into commercial activities, such as your bill proposes, and I don't know what you said on safety and soundness. But in this day and age when we are still trying to absorb the implications of the international global financial grid with the technological advances for fast movement across the globe of money markets and in the wake of the Barings question and the whole subject of using, the D word again, derivatives, which nobody likes to hear, but it's there, I don't know how any of us can have any faith in anybody's definition of what firewalls or safety and soundness are.

I think maybe Mr. Lackritz—and what I've heard him say, but not in his testimony, has gotten closest to giving us some kind of a definition. But the last thing in the world that will lead us to safety and soundness and enforcement of firewalls is a politicized

board, such as the Chairman has just alluded to, that's proposed in the Administration bill.

Now, I don't know if anybody would like to respond to that, particularly if you'd like to respond to the Barings example and how it would be dealt with under the regulatory proposals that you've professed allegiance to. Mr. Fink, yes.

Mr. FINK. Yes. I want to respond, if I could, to the Chairman's remarks, as well. In the hypothetical I gave, where a large securities firm acquires a small bank, it could be that an independent regulator would be better than the committee, but it might be the SEC, which is an independent agency who is very tough on firewalls.

My point was more dubiousness about having a bank regulator always as the independent entity over the holding company. That was simply what I was trying to say.

Mrs. ROUKEMA. Mr. Lackritz.

Mr. LACKRITZ. Yes, to follow up on that point. In terms of the Barings situation, I think the concern is—if we were to hypothesize than an insured financial institution or an insured depository institution fell into some trouble because of activities that they engaged in, as long as we had clear functional regulation and the banking regulators working with the insured depository institution, the securities regulators inspecting and auditing the broker/dealer, and you had clear firewalls there, I think you clearly would contain that problem within the walls of that institution.

It wouldn't spread to the rest of the holding company, number one, and it wouldn't effect the taxpayers, number two.

Mrs. ROUKEMA. None of the bills before us have such a division there, have they? Not as far as I understand.

Mr. LACKRITZ. Well, structurally, yes. Actually, Chairman Leach's bill has it.

Mrs. ROUKEMA. Is closest to it.

Mr. LACKRITZ. Well, he has a financial services holding company and there are firewalls between and among the affiliates. The question I would raise——

Mrs. ROUKEMA. But he does use the Fed as the umbrella agency.

Mr. LACKRITZ. Well, yes, although that's—yes. He has the Fed overseeing the holding company. And the question I think comes up. There's a difference between overseeing the holding company and regulating the activities of affiliates of the holding company.

The concern that we have, as Mr. Fink, expressed, was to not have a bank regulator regulating capital markets activities of a broker/dealer. That's the concern that we had.

Mrs. ROUKEMA. I see. All right.

Chairman LEACH. Would the gentlelady yield?

Mrs. ROUKEMA. Yes, I'd be happy to yield.

Chairman LEACH. Just so, again, there is no misunderstanding, the Fed plays a role in the legislation we've set forth. But we do have very precise functional regulation of which the SEC regulates precisely the activity that you indicated.

And like Mr. Fink or at least like Mr. Fink may have implied, the SEC is a strong regulator. I'm a very strong advocate of the SEC and a role for the SEC. There is no preemptionship in that regard of the Fed versus the SEC in this crucial area of capital

markets regulation, which is very definitively the province of the Securities and Exchange Commission under the approach that we've crafted.

Mrs. ROUKEMA. I appreciate your clarification, yes. Thank you. Mr. Baptista.

Mr. BAPTISTA. I might add just a little bit. Notwithstanding your concerns on banking and commerce, one of the things the Baker bill does is provide the bank regulator the ability to track transactions outside of the bank. So they can examine the books and records of any affiliate of the bank, including the holding company, to assure compliance with the standards vis-a-vis transactions with those affiliates or so-called firewalls.

We simply believe, and I think we come to the same conclusion that the Chairman came to, that there is a need for flexibility as it relates to those firewalls because market conditions change. The regulator has the authority——

Mrs. ROUKEMA. But can you define that?

Mr. BAPTISTA. Well, I guess what I mean by that is you should give the regulator the authority to go both ways. If he sees a condition or she sees a condition in a particular institution that would perhaps present a greater risk, they should have the ability to step in and make adjustments as to what type of transactions can take place.

Just as if there is an institution where there is much less perceived risk, they should have the flexibility to reduce those restrictions.

Mrs. ROUKEMA. In any of these systems of regulation, you would have said that they should have detected it and interposed itself in Singapore.

Mr. BAPTISTA. There is no——

Mrs. ROUKEMA. Mr. Lackritz says yes.

Mr. LACKRITZ. Absolutely.

Mr. BAPTISTA. I would say they should, but there's no system of regulation today, tomorrow, nor has there ever been that's foolproof.

Mrs. ROUKEMA. But it's not management and disclosure. Now we're talking about regulation, regulatory authority, which, up until recently, I wasn't able to get anybody to concede regarding the derivatives market. They talked about disclosure, they talked about better management, but there should be a regulatory responsibility here, it seems to me. No? All right. We'll let it go at that.

Chairman LEACH. Let me thank you all for your very thoughtful expositions on your perspectives. Mr. Lackritz may represent a fractious community, but he's one of the least fractious leaders in Washington, DC. today.

Mr. LACKRITZ. Thank you, Mr. Chairman.

Chairman LEACH. And Mr. Fink has presented a very thoughtful perspective. Mr. Baptista is not only thoroughly intelligent, but extraordinarily persistent. You've been at this for a long time, Sam. And Jeff has a great reputation up here.

But let me come to something that I think is critical to all of this. As you know, we all represent different perspectives and one of the important things is to present those perspectives. Mr. Baptista rep-

resents a group of institutions that, from their perspective, would prefer a given model.

But what, Sam, is the social good of combining Ford and Aetna and Chase Manhattan? What is it?

Mr. BAPTISTA. Mr. Chairman, I don't think that Ford is interested in acquiring Chase or Aetna. What Ford Motor has chosen or any company that chooses to get into the financial services business, they do so because they think that it's a good business to be into.

They simply want the same competitive opportunities in financial services; that is, to serve their customers. Now, in this case, they've chosen to serve those retail customers. It's the consumer. It's not the commercial customer that they're interested in serving. They simply want to be able to offer those products to those customers.

The social good, I think, in this case is the same social good that comes from removing barriers to affiliations within the financial services industry, and that's bringing competition to the marketplace, which is going to provide more service to consumers, lower costs, and more competition.

Chairman LEACH. Well, I appreciate that. Let me just tell you my concerns. I think there is a definitive distinction between the word "competition" and "conglomeration." When you merge these industries, you clearly get conglomeration. Whether you increase or decrease competition is a very different circumstance.

The models that have been developed and examples around the world are not one of an increasing competitive environment. To wit, we look at Germany. There is no increase in competition on the sale of automobiles because Deutsche Bank owns part of Daimler-Benz. There's no increase in competition of banking because of that circumstance. Rather, there are lots of models where there is a decrease of judgment and failed circumstances because of that judgment.

I spoke recently with a former German central banker who made it very clear to me, in one way that caught me off-guard, that if you have a single bank and two widget makers in town and the bank owns part of one of the widget makers and not the other, you may not have a circumstance in which the bank gives preferential loans to the one it owns part of.

One of the odd aspects is sometimes it's the reverse. The bank wants to get a higher income from the widget maker that it owns so it charges a higher rate of interest, which is an odd phenomenon. In his judgment, it was an aspect of German society that caused the bank to have a preference not for the widget maker it owns to become better capitalized, but less well capitalized. It took pressure off capitalization for the entity that it owned because it wanted to make loans.

Now, the only reason I raise that is that, A, it is the exact obverse of what I thought might be the circumstance, but, B, it shows that the minute you have a situation of this nature, you have a whole series of problems you don't visualize in advance.

Unless you can make a compelling case that there is a social good for conglomeration, I think all you're representing is the best interest of a very few market participants. And that doesn't mean

these market participants themselves aren't highly ethical, highly responsible.

But let me, in abstract, say to you, for example, I'm a Ford dealer in Davenport, Iowa. Do I want Ford Motor to invest in CitiCorp or do I want Ford Motor to put its resources into building a better car than GM has and that the Japanese have and that the Germans have?

And I have to think to myself there is no public demand for the approach that you're advocating. Unless you can either present to this Congress a public mood that says we want greater conglomeration, a social good that can be defined as saying it's in the national interest, I have a hard time doing anything but sitting and listening to all of you, in as respectful a way as I can, as you advocate a cause that is surprisingly shallow, if not stunningly so.

I gave a speech the other day and I was thinking to myself maybe I was exaggerating, but I'm not sure I was, when I said there weren't 500 people in America advocating the approach that some of you are advocating.

Mr. BAPTISTA. Mr. Chairman.

Chairman LEACH. Yes.

Mr. BAPTISTA. May I respond? I think that there are two issues here. One is the banking and commerce issue and the other is the bringing together of the financial services industry, a true financial services holding company. And let me start there.

I think most people would—I shouldn't say most people. A number of people in the academic community and among the regulators suggest that at least the bringing together of the financial services industry creates a social good, allowing affiliations of all providers of financial services.

It is very difficult to try to bring that about without some gray areas.

Chairman LEACH. Let me stop you right there. Are you suggesting that you're willing to accept a bill that brings together investment banking and commercial banking? Or where do you draw the line? Investment bank, commercial bank and insurance?

Mr. BAPTISTA. I say financial services holding company. In that regard, I talk about any provider of financial services. So that the bill works for Traveler's, Prudential, CitiCorp, Chase, Morgan.

Chairman LEACH. But you would stop at the car company, would you not?

Mr. BAPTISTA. I would not stop at the car company. Now, what I would do is I would come back and explore perhaps—and right now let me speak for myself. This is not a policy that's being developed by the council.

Chairman LEACH. Before you finish, let me say it is my impression that your organization is all or nothing. Am I wrong?

Mr. BAPTISTA. Yes, you are.

Chairman LEACH. So you're willing to stop at insurance and accept it.

Mr. BAPTISTA. We would not be willing to say today that we would not continue to support and advocate broader reforms, just as we are not here to oppose your bill, H.R. 1062.

Chairman LEACH. You're not?

Mr. BAPTISTA. No.

Chairman LEACH. I think we ought to adjourn right here.

Mr. BAPTISTA. I'm kind of like the Dicken's character, Oliver; I'm here to say please, sir, I'd like some more. I think in this case, though, it's very difficult to simply say banks, securities and insurance, recognizing that if you stop and looked at the activities of these financial services holding companies that exist in the marketplace today and that are purely financial in nature, they're not quite so pure. All exist with some gray area. And the more we develop technology, the more that gray area comes into play.

I do think if you take a look at—and I hate to use the example of Ford Motor, but they happen to be the only true commercial firm that's part of the Financial Services Council. They own today the Associates. The Associates today owns a credit card bank. Congress, in 1987, specifically authorized any company to be able to own a credit card bank.

They are precluded in that credit card bank from issuing corporate cards, cards that can be used for business purposes. They feel that there are some legitimate things that they can be doing that they today are foreclosed from doing. As I said, they are also a participant in the financial services business. They don't want to be left behind. They don't want to own Chase. They don't want to go out and buy CitiCorp. But they need to have some avenue into the market.

Chairman LEACH. I appreciate that. Let me bring this to an end. But let me say even though someone may think they may not want to do something, I will tell you that it strikes me as next to impossible, if we pass the broader bill, that you would not see the greatest number of companies in play of all varieties in the history of the United States.

In my judgment, this would cause right at the very beginning massive new leveraging within American society. Now, granted, you can have some mergers that would just be stock-to-stock, but almost from the very beginning someone is going to do a borrowed buy-out and it's just going to be trip wire.

I ask you as we look at our society and question all of American industry do we have enough capital versus too much borrowing? Haven't we encouraged leveraging versus the building up of capital not only in banking, but everywhere else. I have concerns about this leveraging and I have doubts that we will be better able to compete in the world.

So even though you might suggest that no one has this as a particular intent, everybody is going to be looking sideways and coming up with new ideas. And the question is who is going to be first out of the box. Is Aetna going to buy Ford? Is Ford going to buy Aetna? Is Chase going to buy Prudential? Is Prudential going to buy Chase? I don't know, but I think everybody is going to be racing to be the one doing the buying instead of the person being bought.

I'll tell you, as a national legislator, in the end, how can one say America is better off? And I just have great doubts, although what everybody has said about this differentiation within the financial services community has to be taken very seriously. There are lines that all of us are going to have to think through, but I'll be darned if breaking commerce and finance is one that I find very helpful.

Listen, we've gone on fairly long. Dick, did you want to raise a question?

Mr. CHRYSLER. No.

Chairman LEACH. Let me thank you all and the meeting is adjourned.

[Whereupon, at 4:07 p.m., the hearing was adjourned.]

H.R. 1062, THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995, GLASS-STEAGALL REFORM, AND RELATED ISSUES (REVISED H.R. 18)

WEDNESDAY, MARCH 15, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room 2128 Rayburn House Office Building, Hon. James A. Leach [chairman of the committee] presiding.

Present: Chairman Leach, Representatives Roukema, Bereuter, Baker, Lazio, Castle, Lucas, Barr, Chrysler, Heineman, LoBiondo, LaFalce, Schumer, Kennedy, Flake, Orton, Maloney, Barrett, Velazquez, Wynn, Watt, and Bentsen.

Chairman LEACH. The committee will come to order.

We begin today again with a further review of the issue of Glass-Steagall. Our first witness is the distinguished Chairman of the Securities and Exchange Commission, a man of great reputation in this town and around the world, Mr. Arthur Levitt, and you are accompanied by Mr. Brandon Becker, and what is your title, sir?

Mr. BECKER. Director of the Division of Market Regulation.

Chairman LEACH. Good. Well, you are welcome, as well, Mr. Becker.

Mr. BECKER. Thank you.

Chairman LEACH. Mr. Levitt.

STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY BRANDON BECKER, DIRECTOR OF THE DIVISION OF MARKET REGULATION

Mr. LEVITT. Chairman Leach and members of the committee, I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding H.R. 18, the Financial Services Competitiveness Act of 1995.

Let me begin by thanking you, Mr. Chairman, for advancing the dialogue on Glass-Steagall reform and financial services modernization and for holding these hearings.

Before the enactment of the Glass-Steagall Act some 60 years ago, banks were significant participants in our Nation's capital markets. Indeed, by 1930, bank affiliates were sponsoring over 50 percent of all new securities issues, and 41 percent of all commer-

cial bank assets were invested in securities or securities-related loans.

This involvement in the securities markets came under close scrutiny after the 1929 market crash. The Pecora hearings of 1933, which focused on the causes of the crash, uncovered a wide range of abusive practices on the part of banks and bank affiliates. These included a variety of conflicts of interest, the underwriting of unsound securities in order to pay off bad bank loans, and "pool operations" to support the price of bank stocks.

Revelations about these and other abuses reinforced concerns about the role that banks played in fueling the speculative fever of the 1920's. They also compounded fears that the securities activities of bank affiliates threatened bank safety and soundness and, therefore, the public interest. Ultimately, strong public reaction to the Pecora hearings prompted the enactment of the Glass-Steagall Act, which tore down the bridge between commercial and investment banking. Because banks were barred from most securities activities, it was logical also to exclude them from the Federal securities laws.

That logic no longer applies. Expansive banking agency interpretations over the years have given banks a beachhead in securities terrain. Banking firms now engage in such activities as providing investment advice or other services to investment companies, selling mutual funds, and operating underwriting and broker-dealer affiliates. At the same time, however, banks remain exempt from the securities regulatory framework and its numerous important protections for investors. If this state of affairs confuses regulators, one can only imagine its impact on investors and depositors.

Clearly, we need to modernize and to rationalize the financial services regulatory structure. The Glass-Steagall Act has served its purpose honorably and well, but the time has come to retire it. I come before you today to offer the SEC's support as you seek to build a new bridge between banks and the securities industry. But I'm also here to remind all concerned that, unless corresponding changes are made in the regulatory regime, it's likely that the new span will fall, too, because of a flawed design.

The Commission believes that H.R. 18 is a very thoughtful piece of legislation and a good first step in reopening the Glass-Steagall debate. We certainly support the bill's principal purpose, to permit banks to participate more fully in the securities business through affiliated companies. Sound reform could provide banks with greater flexibility and new avenues for innovation. By bringing new competition to the market for securities services and products, such changes could benefit investors in the financial markets as a whole. Moreover, rationalizing the rules for financial services would surely reduce costs, costs to public taxpayers as well as to private businesses, by eliminating regulatory redundancies.

However, I would point out that there are other equally important perspectives to consider as Congress contemplates precisely how to link the banking and the securities industries. Your actions are likely to have as profound an impact on investors and capital markets as on banks. As the debate moves forward, the SEC will stand up for two key principles—principles by which our securities markets have flourished, and which must never become diluted

among the many additional and very valid concerns when banks are brought into the picture.

First, the interests of investors must come before all others. Investors will benefit if they can choose from a wider array of financial products and providers, but they should not be expected to give up basic safeguards in the process. Those who invest in bank-sold securities deserve the same high standard of protection enjoyed by those who invest in securities sold by traditional brokerage firms. Moreover, the changes we make should allow for no confusion as to whether people are investing in insured products or uninsured securities instruments. As Congress weighs giving banks new securities powers, investor protection must be an explicit priority.

Second, any changes that we make must preserve the vitality of our capital markets. Working within a regulatory framework painstakingly developed over 60 years and supervised by the SEC, American capital markets have underwritten our Nation's extraordinary economic success, raising funds to support new industries and to create new jobs. That money has come directly from private investors, without the benefit of Federal deposit insurance.

The securities industry is characterized by risk, by fierce competition, and by a regulatory framework that is sensitive to market forces and seeks to use them wherever possible to solve problems. In order to preserve the vitality of our capital markets, risk-taking by securities firms must be allowed, and the markets must not be stifled by bank-style safety and soundness regulation.

The Commission is pleased that H.R. 18 attempts to address these issues through provisions that would promote functional regulation of bank securities activities. The Commission strongly supports the principle of functional regulation; we have long maintained that, if banks are to gain full access to the securities industry, it is important—indeed, essential—that they follow its time-honored rules.

Just imagine extending franchises to a host of new baseball teams without also bringing them under the regular rules of the game. I guess you would have chaos, not to mention unfairness, as teams that allowed four outs per inning and five innings per game played against teams with the standard three outs and nine innings. Come to think of it, considering the shape of some of the replacement teams I have seen on the news, they may need the head-start of four outs per inning and five innings per game.

There is a clear difference between banking regulation, which traditionally and appropriately focuses on the safety and the soundness of the banking system and the protection of depositors, and securities regulation, which focuses on investor protection and the maintenance of fair and orderly markets. Bank securities activities should be subject to the same rigorous requirements that apply to the securities activities of non-bank entities, consistently administered by a specialized regulator. American investors deserve a single high standard of protection, a standard of protection that they have come to accept through the years and that they have come to trust.

H.R. 18 also contains important provisions that would facilitate regulatory coordination and information sharing. These provisions recognize and build on the concept of functional regulation and are

intended to promote efficient regulation that does not unduly burden the operation of our capital markets.

The SEC strongly supports the thrust of all of these functional regulation provisions, but we believe investor protection might be undercut by the numerous new exemptions that the bill would grant banks from the securities law. Likewise, more can be done, we believe, to clarify and strengthen the provisions aimed at achieving what FDIC Chair Ricki Tigert Helfer described as "seamless" regulatory coordination.

A final concern I would like to raise today is the burden H.R. 18 would place on securities firms that acquire banks under so-called "two-way street" provisions. It strikes me as unfair to require such firms to divest themselves of commercial holdings and unproductive to saddle them with radical changes in their regulatory regime. If I may extend the metaphor, these burdens are tantamount to a major roadblock on one side of the street, and they threaten to make it two-way in name only. For financial services reform to work, it must provide brokers with a meaningful opportunity to compete.

As we consider this and other issues, we need to worry less about turf and more about common ground. Our capital markets tomorrow will create things we regulators just cannot possibly dream of today. The market's capacity to innovate far exceeds our ability to anticipate and to legislate. In contrast with the current medieval system of realms, domains, and fiefdoms, each with its own lord and laws, we need a system that follows the logic of our markets, organizes activities according to function, and can grow with those markets instead of being shed every so often like some old skin.

The SEC certainly appreciates the enormity of this committee's task. Glass-Steagall reform raises additional complex issues, including firewalls and conflicts of interest. In all of these areas, I think a balance should be achieved among bank safety and soundness, fair and competitive securities markets, and protection of depositors and investors. And while we speak about financial services integration, let us not forget that there is a third major player besides banks and brokers, and that is insurance companies.

Mr. Chairman, I believe we are at a historic juncture. The opportunities are exciting. I would be remiss in my duties, however, if I did not also cite some of the dangers. We are not dismantling Glass-Steagall in a vacuum but in the context of several significant systemic changes. At the same time that this committee liberalizes bank policy, Congress is moving to adopt curbs on Federal rulemaking which could hamper the ability of regulators to maintain discipline in the financial markets, and it is proposing limitations on private rights of action in litigation. Each of these changes individually presents some risk to the capital markets. No one can predict what the cumulative effect might be if all of them are adopted simultaneously. History has shown that, even if a law is right, it can have unintended consequences if the moment is wrong. This multiplier effect would seem to counsel that Congress should proceed with caution.

None of that is to take away from the fact that, in terms of financial services reform, H.R. 18 is certainly a major and important step in the right direction. We believe that its introduction has per-

formed a real service to the American people in enhancing the debate on a question of vital importance to the future competitiveness of our Nation. As you move ahead on this issue, the SEC looks forward to working with the members of this committee constructively to meet our shared goals of protecting investors and maintaining the soundness and preeminence of American markets.

Thank you.

[The prepared statement of Hon. Arthur Levitt can be found in the appendix.]

Chairman LEACH. Thank you, Mr. Chairman, I appreciate your thoughtful statement. I would like to just clarify a couple of points.

One relates to the issue of whether securities activities should be conducted under the umbrella of a holding company or through the bank itself in a subsidiary. As I read your testimony, you are strongly in favor of a holding company structure. Is that correct?

Mr. LEVITT. That is correct.

Chairman LEACH. As you pointed out, we have tried to maintain the principle of functional regulation, although at the margins you have some differences. As a general proposition, you are supportive of that approach, are you not?

Mr. LEVITT. Yes.

Chairman LEACH. Would it be fair to say that it is easier to conduct functional regulation through a holding company structure than through a bank subsidiary structure?

Mr. LEVITT. I think it is.

In fairness to those who have proposed a subsidiary structure, they argue that the same protections can be put in place which would exist in a holding company structure. Again, my experience through the years is that this is really not a matter of law but a matter of practice, and the kinds of protections that one would arrive at as a result of having a holding company structure, I believe, are far more significant in addressing these issues than would otherwise be achieved in a subsidiary, regardless of the legal protections that might be built into such structures.

Chairman LEACH. Fair enough.

I would like to turn to the second issue. I am not sure you may not be overstating your case. You have expressed certain concern that our legislation does not have a two-way street.

In fact, doesn't this legislation effectively accomplish the two-way-street goal? It authorizes firms that are engaged in financial services to affiliate with banks under the same conditions as banks can affiliate with securities firms.

Your objection seems to be that, if a securities firm were to affiliate with a federally insured bank, that it would come under Federal Reserve Board supervision. Well, that is the way all banks operate today, and I do not know what your objection to that would be.

Mr. LEVITT. I do not want to paint any of this in black-and-white. I think that you have been extremely fair in terms of balancing the interests of securities firms and banks and keeping in mind protections to both depositors and to investors.

So, I am not saying that the bill is totally mindless of the two-way street, but we do have concerns that securities firms would be subject to consolidated supervision by the Fed in order to avail

themselves of bank access; we have concerns that firms which have other enterprises that they have acquired through the years might have to divest themselves of those enterprises.

The Fed's regulation of the holding company, we feel is not warranted.

This type of supervision, we are concerned, would impose costs and could discourage investment by securities firms in banks. It also might combine disparate balance sheets to which different forms of prudential capital requirements apply. If I were to characterize the greatest concern I have with this, it is the danger that consolidated oversight would stifle the kind of entrepreneurship which is part of the securities industry and which, I think, is a terribly important part of what it does and should continue to do.

Chairman LEACH. Well, I appreciate that. I would stress that we maintain a very strong role for the SEC, and I consider myself a member that is a strong supporter of the SEC——

Mr. LEVITT. Absolutely.

Chairman LEACH. And I do not personally view rival regulation as a great problem in this regard. However, as in any legislation, there are a series of subtleties, and I would like to submit some questions to the SEC in writing that might follow up on some of these and other points. We would appreciate any cooperation you could give us in this regard.

Mr. LEVITT. Absolutely.

Chairman LEACH. Thank you.

Mr. LaFalce.

Mr. LAFALCE. No questions at this time. Thank you.

Chairman LEACH. Mr. Orton.

Mr. ORTON. Thank you, Mr. Chairman, and Chairman Levitt, thank you for your attendance and your testimony.

I think you have, in your testimony, included some very constructive suggestions with respect to both H.R. 18, as well as H.R. 1062, and I, too, am concerned about iron-clad safeguards to protect not just the taxpayer in the guaranteed deposit situation but also the investors in securities firms.

I am concerned partly because of the acknowledgement—when Chairman Greenspan was here, in talking about firewalls, he indicated that firewalls tend to melt, and in H.R. 1062, those firewalls may be considered illusory if the Fed can simply ignore them, and so, what I am wondering is if you have any—I imagine this is part of the reason why you believe the holding company approach is better than the subsidiary, but I am wondering if you could comment specifically on firewalls and if you are familiar with the firewall approach that was developed with the Energy and Commerce Committee in 1991, if you think that is a better type of firewall approach or what you would recommend.

Do you think firewalls would better serve the public interest in preventing conflict of interest and inappropriate conduct if they were structured similar to what is in H.R. 1062, what was in the Energy and Commerce approach?

Mr. LEVITT. Well, I do not think you talk about firewalls unless you are afraid that people may get burned, and I think that they have to fulfill their purpose in protecting investors, depositors, and taxpayers.

Obviously, the Commission believes that firewalls are extremely important. They can help to protect bank safety and soundness by insulating banks from the risks of their securities affiliates. To the extent that firewalls are predicated on bank safety and soundness concerns, the Commission generally defers to the Congress and the banking regulators.

The Commission has had a great deal of experience in terms of firewalls involving conflicts of interest with respect to the securities industry, and I think that any of us who have dealt with markets understand that the very best of firewalls represent no total iron-clad guarantee against problems.

The nature of markets is that they are unpredictable.

The kinds of products that we are seeing today, the proliferation of those products, and the increased areas of involvement of securities firms in a whole host of different activities suggest that firewalls are critically important. But I think overlaying all of this is the ability of the regulator, by virtue of experience, by virtue of the smell test, to anticipate a problem before it develops and, perhaps even more important, once that problem develops, to have the kind of flexibility to be able to be responsive.

So, yes, I think firewalls are critically important. I think that what you have done insofar as safety and soundness of the banks and firewalls is a step in the right direction.

I think, again, being certain to preserve the time-honored commitment of bank regulators to regulate the banks and securities regulators to regulate securities firms, based on their experience with the kind of disruptions that firewalls are intended to anticipate, is the best way to see to it that they work and work properly.

Mr. ORTON. Thank you.

I see my time is about expired, but I will put out one additional question, which you may want to respond to in greater detail in writing, and that is which specific exemptions contained in the new definition of broker and dealer do you believe should be removed from the bill and which do you think are appropriate to remaining in the bill?

I know that you have indicated some concern about the exceptions to the broker/dealer rule, and I just—I would like some, perhaps, expansion on your thoughts of which specific ones should be removed or remain in the bill, and you can do that in writing if you'd prefer, rather than in here.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Orton.

Mrs. Roukema.

Mrs. ROUKEMA. Mr. Levitt, Mr. Chairman, my question was, to some degree, asked by Mr. Orton, but I do not know that we have had a satisfactory answer here, but that is OK, Mr. Chairman, because we did not get a—I did not get a satisfactory answer from anyone, and I have asked the question, in one form or another, of everyone who has testified here.

Before I go into the question, I might say, because it is related, I do appreciate the fact that you spent some little time expressing some—giving us some historical background as to why Glass-Steagall was instituted in the first place and maybe referencing the fact that we should, in reforming it, bringing about necessary re-

forms, should avoid inviting the same kinds of problems that we had in the 1920's, and so forth, and in that regard, I especially appreciate the fact that you referenced that we are not dismantling in a vacuum—I think those were your words—and you referenced the deregulatory fever that is going on here, and I appreciate that. That is my concern, too.

Getting down to the question of firewalls—and I just asked staff—suddenly Chinese walls have fallen from the vocabulary, but in the debate of a few years ago, Chinese walls and firewalls were used all the time, but let me try to get to something that is a little more specific here, because I really do value your judgment in how you construct these Chinese walls or these firewalls.

In the wake of the Barings fiasco, I asked the question of Mr. Greenspan and others—and I think it was in that context that he said, you know, under stress, firewalls melt. That was my exact reference, and in the context of that, Barings and derivatives, firewalls may melt.

I think the general answer that we got back—and I am not quoting anybody here, but the general answer was, well, you have to rely on good management and you have to be—the regulators have to be able to anticipate problems.

Well, I wish you would amplify on that, particularly in a specific case like—whether it is derivatives that caused Barings or something else that could cause that kind of a financial meltdown, especially in—with the knowledge— as Mr. Greenspan very eloquently pointed out, one of the compelling reasons for these kinds of changes is because of the changes in global capital markets and the technology and the speed with which capital is transferred.

I mean it is a compelling argument for dismantling Glass-Steagall as we know it, but we have to leave something in its place, and I have got to tell you, quite frankly, I am not convinced that management can deal with a Barings—management in quotes—I do not know what management means—nor do I believe, necessarily, that I have been convinced that the firewalls as described in any of this legislation might be adequate to that problem.

I value your experience, and could you focus on the subject in that context?

Mr. LEVITT. Surely. You ask a question that really is at the heart of this issue, and I will share with you my own personal experiences and feelings.

I think anyone who went through 1987, as I did, running a stock exchange and anticipating at that point that our markets might shut down, has had to focus on some attitudes and judgments that I think perhaps are relevant.

I think there are three elements that come into play here: in the first place, leverage, good capital; second, good management controls; and third, good risk assessment.

Any one of those you probably could go without. If you had the other two, I think you would be able to get through a crisis. But the important point, I believe, is that I do not think there are any series of regulations or firewalls, no matter how artfully crafted, no matter how tightly structured, that could give an absolute guarantee against problems.

I think what is important is that firewalls or regulations or whatever you want to call them may give you some time, and that is critically important at a time when the velocity of products available today internationally has so much exceeded anything that we have experienced in the past. Time, in terms of giving the regulators of banks or of broker/dealers an opportunity to deal with the systemic disruptions that those problems could cause, is terribly important. I think what I would suggest is the kind of flexibility where the banking regulators are given the freedom to act with respect to the banks and the securities regulators with respect to the securities firms. But you do not depend upon the firewalls to cover everybody, nor do you depend on one regulator, no matter how experienced, no matter how great the reputation may be, to cover all bases.

So, there will be episodes similar to the Barings one. I guess I have learned that the problems that you anticipate are rarely the ones that occur, and the Barings problem is not unique.

Franklin Bank failed as a result of the activities of a rogue dealer. It clearly represented management problems and a host of other problems that have yet to come out.

I think your general approach to this issue is sound, but I would urge you not to expect that the firewalls can do it by themselves. They must do it in conjunction with the kind of oversight that combines experience and flexibility and maybe some portion of good fortune, as well.

Mrs. ROUKEMA. All right. Thank you.

We will pursue this further as we go along. Any further written statements you might want to put in the record with respect to the definition—the explicits of the firewalls I would appreciate.

Chairman LEACH. Before turning to Ms. Velazquez, let me just make one comment that I would like to indicate particular appreciation to the SEC about, and that is that, in regulating broker/dealers, the SEC requires mark-to-market accounting, something, frankly, the banking regulators do not.

Mark-to-marketing accounting is perhaps the single most important firewall although, not to imply that it is an adequate firewall in all circumstances. It is an important firewall, and that is one of the reasons that I strongly favor a role for the SEC in functional regulation.

Because we come from a banking committee perspective, we sometimes lost sight of probably the single most important differentiation in regulation of the two kinds of institutions.

Mr. LEVITT. It is more important today than ever before. It really represents market discipline at its most fundamental level.

Chairman LEACH. Yes, I agree.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you very much, Mr. Chairman.

Most of my questions have, indeed, been asked by Mr. Orton, but I do have some concerns, again going back to firewalls and the pressure that Glass-Steagall reform might place on insured deposits.

From your perspective, how much concern should the American people have about the improper use of insured bank deposits? How

significant is the danger that the banking industry might indulge in ill-advised risk if it got into the more risky securities business?

Mr. LEVITT. I think that, like anything else, when you're dealing with new methods of delivering products that were previously delivered in a different fashion, it takes a period of time to educate the public.

About a year ago, the Commission embarked upon a survey that found, unhappily, that over 60 percent of people that had bought mutual funds from banks believed that they were insured products.

As a result of the publicity and dialogue that developed after the study was revealed, I believe a similar study today would indicate a much smaller percentage of the population believe that those funds are insured.

I think that a bank, almost by virtue of its name and its history, has an image in the minds of most investors and depositors, an image of safety and soundness and security. That is terribly important as we view these issues. Because it is essential that investors are able to distinguish between products that are guaranteed and insured and those that are not. It is essential that those products that are guaranteed and secured not be jeopardized by activities that, almost by definition, are more risk-oriented. And, as we consider legislation, it is important that we draw this distinction. We must be rigorous in seeing to it that misunderstandings of this kind, whether they be created by misleading advertising or using names similar to the parent bank name in products sold by the bank, that we be absolutely rigorous in seeing to it that that kind of deception is not allowed.

Ms. VELAZQUEZ. Your testimony also touches—and we discussed this before—upon tensions between the jurisdiction of bank regulators and that of the SEC. Can you discuss in more detail the substantive impact of overlapping regulation as regards consumers and taxpayers?

Mr. LEVITT. I think that we have learned through the years that, ultimately, the cost of redundant regulation, if you will, is borne by the consumer. There is a point, clearly—and I speak as a regulator—when over-regulation clearly distorts the market process.

Our markets are so remarkably resourceful and resilient and are doing so well at this time, largely because, I think, regulators have been sensitive to the importance of allowing them to do what they do best—take the risk of success along with the risk of failing—to make those markets true markets. True markets are ones that do not guarantee investors against failure but make certain that disclosure of all the elements of risk are made known and that those markets are fairly and openly policed.

As far as I know, the bank regulators of this Nation have manifested a similar commitment in terms of bank depositors.

However, the focal point of bank regulation has been, appropriately, safety and soundness, and the focal point of securities regulation has been almost an obsessional dedication to investor protection.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Ms. Velazquez.

Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Good morning, Mr. Levitt, and welcome again. I join with you in again complimenting the Chairman on his role in proposing modification to Glass-Steagall limitations on bank practices in securities markets.

I was particularly taken, however, by comments of your written testimony on pages 17 and 18 where you discuss two-way-street issues and commerce and banking questions, and you recite the fact that broker-dealers are often affiliated with insurance companies that may hold equity investments in commercial firms as a result of merchant banking activities and that these firms will be unable to take advantage of any two-way street if divestiture of such investments is required.

As a footnote to that statement, you go on to say that a possible remedy is the separation or elimination or alteration, rather than elimination, an alteration of the existing separation between commerce and banking so as to allow combinations of banking, insurance, and other financial activities; under such approach, it would be appropriate to provide for regulatory coordination, so forth, basically saying, if you were to propose such a step, you should assure functional regulation.

Later on the page you discuss what might be potential damages of such a proposal based on the Commission's historic oversight of these activities, indicating that, from time to time, commercial parents provided a ready source of capital to their affiliated broker/dealers.

Again, in a footnote to that, you recite a particular instance in which a commercial entity, generally defined as commercial entity, helped provide resources to a subsidiary involved in securities matters, as well as an insurance company.

The point I guess I am trying to raise here is that, based on your comment, it appears the market has, in fact, very much diversified over time.

Despite the best efforts of this Congress and regulators to date, markets find a way to deliver product in a safe and sound manner to customers who need that service.

It would seem more efficient for us to, in this discussion, look at all possible alternatives for restructuring that might take us into the next decade rather than perhaps just regulating to the problems of the immediate past.

Supporting that argument would be the observation that, if we were to be totally risk aversive, we should perhaps discuss the advisability of continued derivatives activities, but not one regulator to date has come forward and said derivatives are inherently bad, they should be carefully monitored, watched, purchasers advised, even perhaps suitability requirements determined, but not necessarily prohibit the market from producing a product which may be filling a legitimate market need.

In your comment, you are particularly directing your view toward the securities interest and to H.R. 18.

In light of these footnotes in the written testimony, do you see a philosophic advantage to a lessening of the barriers to commerce and finance, and is the principle concern how we regulate that new world and the second concern how we limit risk to taxpayers in the event an affiliate of such a structure would have sustained losses

of consequence that come back through the holding company, leap over the firewall or run through it, get to the depository institution, deplete its capital assets, and therefore jump into the taxpayer pocket?

If we are able to somehow limit that exposure, is it a possibility that this Congress should look toward a modernized system that allow commerce and finance rather than just the step of Glass-Steagall repeal?

Mr. LEVITT. Well, I think that one way of addressing this, obviously, would be the tightest possible kinds of firewalls, the highest kinds of firewalls, but I recognize the dilemma that you face, and I do not want to overstate the case for ripping asunder every rule, every law, every impediment.

I have found that American commercial society is remarkably resourceful in its ability to adapt to laws, even bad laws, and that, when you do violence to that system by suddenly changing the ground rules, they become less accommodating than if you go at this more thoughtfully.

I am not suggesting that any member of this committee has not been thoughtful. I am suggesting that there are risks involved in any course that you take.

I would personally like to see securities firms able to avail themselves of the commercial relationships which, by and large, have been very constructive for them. We cited a number of examples of that, and I guess I am concerned about the fact that they would have to sever those relationships under certain circumstances.

At the same time, I am aware of concern expressed by this committee about the implications of combining commercial and financial activities. I think that where I have the greatest concern, however, is allocating to any one entity the ability to say this is good and this is bad.

Chairman LEACH. If I may—I am sorry, because we have the second bells, and I want to just do a quick followup. If there is not sufficient time to respond——

Mr. LEVITT. Yes.

Mr. BAKER. Maybe in writing—but it appears that your historic regulatory role indicates a value in some instances to—liquidity value in having differing parties join together in business ventures; second, that those business ventures ought to develop products they deem appropriate for the market; and third, regulators should be given the authority to step in quickly where the public interest should be protected and taxpayer money preserved.

In that very broad description, it seems to fit the history and practice of securities firms and, in a broader sense, what is going on in the financial marketplace today.

Mr. LEVITT. Yes.

Mr. BAKER. Thank you, sir.

Chairman LEACH. Thank you.

I do not think we have time for you, Rick, if that is all right.

John has one 30-second observation.

Mr. LAZIO. I am just not going to be able to come back. I just wanted to thank the——

Chairman LEACH. Well, of course.

Mr. LAZIO. Chairman.

Chairman LEACH. You are recognized for that purpose.

Mr. LAZIO. Thank you, Mr. Chairman.

I just wanted to thank you for coming, and I will address my questions in writing, if I can do that.

Chairman LEACH. I would like to thank you for thanking the Chairman.

Mr. FLAKE. Mr. Chairman, a unanimous consent request——

Chairman LEACH. Of course.

Mr. FLAKE. I have had the privilege of hearing Mr. Levitt in our black study group. I will not be able to come back. So, unanimous consent to submit questions for the record, with your permission.

Chairman LEACH. Without objection.

Mr. FLAKE. Thank you.

Chairman LEACH. Mr. LaFalce.

Mr. LAFALCE. Mr. Levitt, thank you very much. Unfortunately, we have not had an opportunity to come to know each other, as I have known some of your predecessors, Mr. Jones, Mr. Breeden, but I do want to say that I did have a very close working relationship with your father, who campaigned for me the very first time I ever ran for office for the New York State Senate in 1970, and I do want to develop a working relationship with you similar to the one I had with your dad.

A very brief question.

I am for some of the most broad-reaching modernizations that are being advocated, and yet, I have one very deep concern about that, though, and that deals with mutual funds, where individuals who go to a bank do believe that they are receiving an insured asset when they invest in a mutual fund.

What would you think of the proposal that no bank that offers a mutual fund could use the name of the bank or that, if mutual funds were being—so, the Chase bank could not offer a Chase mutual fund, and conversely, if Merrill Lynch, best known for being in the securities industry, wanted to have a bank, it could not be known as the Merrill Lynch Bank, so that you could not use the same name for both your mutual fund and your bank, to avoid this problem?

Mr. LEVITT. Well, I think you are right. I think that a bank offering a mutual fund with a name similar to the bank is a deceptive practice, again because of the very special way banks are viewed in the United States.

Now, on the other side of that, I do not think that any particular brokerage firm, whether it be Merrill Lynch or whatever the firm may be, has that same kind of psychic imprimatur that a bank would have, therefore, and that provides a different kind of problem. But I think concern over the notion that a mutual fund is either guaranteed by the bank or by Federal insurance or has the same security that the bank has—is something that I would definitely pursue.

Chairman LEACH. John, if I could interrupt here, we have a vote on. The committee will be in recess on this profound notion of a one-way street, and we are adjourned for 10 minutes.

[Recess.]

Chairman LEACH. The committee will reconvene, and before turning to Mr. Schumer, we had one query of clarification, Mr.

Levitt. You are not suggesting, for the record, that the symbol for Merrill Lynch Bank would have to become the bear, are you?

Mr. LEVITT. No.

Chairman LEACH. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman, and I am delighted to have our fellow New Yorker, who has distinguished himself in so many ways in life and in my State and in our country, here today, and he is doing a very fine job as head of the SEC.

The part of your testimony I would like to focus on, which very few of the witnesses have, and it bothers me or troubles me, is the part where you talked about just the fundamental cultural differences between the securities industry and the banking industry.

As I walk around New York, for instance, it is something that it is obvious as the nose on one's face, and yet, no one has paid attention to this, and I have a worry about any of these consolidation bills, and that is that, should securities firms fundamentally develop a corporate, regulated-type structure—and the Federal Reserve is quite a different regulator than you.

You are sort of the bully across the—not bully, we should not say, but the rival across the street, and they are sort of like the big brother. It is sort of a different attitude.

I worry that the thing that I think has kept the American financial services industry so much ahead of other industries—and that is entrepreneurialism, the very essence of risk-taking and innovation and not worrying as much about risk, about regulation, about checking things out with 87 different departments—it leads to big losses, and that is why we do not insure it, but so be it, that is capitalism. It also leads to tremendous gains and great innovation and speed.

The reason I think our companies are better than a Deutsche Bank or than a Dai Ichi Kangyo or even a Nomura is that they are fundamentally entrepreneurial.

My worry—and I would like your thoughts on this, because I am sure you have given it some thought—is that, if these companies are to become, certainly, subsidiaries but even affiliates under a bank holding company structure of the larger institutions, that the cultures do not mesh, and either they stay very risky, and that does not work when you have deposit insurance backing them, but much more likely that their entrepreneurial vigor over a period of years will be sucked out.

In fact, if you look at the two most entrepreneurial banking institutions, not in marketing but in merchant banking, Banker's Trust and, particularly, J.P. Morgan, they want to get out of a banking structure altogether.

So, I wonder—I understand where all the industries are lined up, and some of our biggest securities firms having been buffeted about by the last few years are looking more to safety nets than they used to and looking for capital more than they used to, but I just wonder if we are not making a mistake or, certainly, sacrificing something that has served American financial interests well by having sort of a walled-off entrepreneurial sector and then a less entrepreneurial sector, and you blend the two, and I am worried.

Mr. LEVITT. You are right on.

I totally associate myself with your observations about the importance of seeing to it that that entrepreneurship, that drive for innovation, job creation, whose fundamental purpose is so different from the important purpose and function of banks, is recognized as we fine-tune a piece of legislation which potentially has such an enormous impact on America's depositors, investors, and economy.

I think it can be done, but I think it can be done best with the kind of sensitivity to the different roles performed not only by the institutions but by their overseers and that, by endeavoring to craft legislation which covers everything and everybody under the same rubric, I think you would run into the kind of problem that you cite.

I think that there is a proper way to thread this needle—and it is not easy. It is by, in the first place, having a flexible view of the way this oversight is going to be maintained, seeing to it that bank regulators regulate banks and securities regulators regulate securities firms and seeing to it that securities firms are free to consider new products, new techniques. Securities firms must also not lose their right to fail; their right to fail is the best way to see to it that that spirit is maintained and that those advantages and those risks are part of the process in that fashion.

I think the problem you will run into is if you say that there is one standard or one regulator that will cover the waterfront. That is very difficult, but I think you have approached this and your committee has approached this with a sensitivity and a willingness to adapt this legislation in a way which I think should diminish the likelihood of that risk.

Mr. SCHUMER. Mr. Chairman, might I ask one more question, since——

Chairman LEACH. Yes.

Mr. SCHUMER. Thank you.

Chairman LEACH. Mr. Schumer, you are——

Mr. SCHUMER. Let me ask you this.

I mean this is a minor point or a minor tail to the major dog question there, but do you see any way that we could keep this entrepreneurialism and separation alive if securities firms were to be allowed to be subsidiaries and were, by and large, subsidiaries, as opposed to affiliates, of banking companies?

Mr. LEVITT. Again, this is a tough and controversial issue, and you have heard arguments on both sides of this, and I have, too, that there are all kinds of protections that could be built in that would legally ensure the fact that a subsidiary would be just as tight, just as safe as an affiliate.

I cannot speak to that issue.

I can only say that my experience in the industry and my experience with corporate structures tells me that you are better off in an affiliate structure in terms of the delicate balance of perceptions and treatment in terms of what happens under stress.

Under stress, where do I want to be? I want to be in an affiliate, not in a subsidiary, if the walls are caving in.

Now, that may be the ultimate pragmatism, but that is the best I can offer you in terms of what I have seen and what I have experienced.

Mr. SCHUMER. Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Chairman, and let me just say here, I think we all share these concerns about entrepreneurialism, but I would suggest that there is a little irony in this. While I fully agree with Mr. Levitt's view that it ought to be in a holding company structure, oddly, it may be more entrepreneurial to put it within the bank. Second, one of the reasons I prefer the holding company structure is that, in many ways, the SEC is a sterner regulator than the Federal Reserve, and so, when you talk about entrepreneurialism and who is stern and who is not, on some very important points, particularly in this legislation on mark-to-market accounting and on firewalls, the SEC holds a greater regulatory grip. In my view, in this world we are in, it is important that the SEC does that. The only reason I raise this is that I think one has to be very cautious about where the conclusions are drawn when one uses the word "entrepreneurial," and where the balance judgments are to be made.

Yes, sir.

Mr. SCHUMER. I thank the Chairman. I guess we have some disagreement there on both fronts. I do not see—what I am worried about is almost a cultural point and not even safety and soundness, as the SEC chairman was focusing on, but just the entrepreneurialism.

If you are part of a bank structure or corporate structure, a highly regulated structure, I think it is very hard, even if you have some firewalls of the kind we could write, to prevent the culture from seeping down.

Mr. LEVITT. If I can rephrase what you are saying, I think the danger is letting synergy become homogeneity. I guess some of the bank exceptions and the allocation to the Federal Reserve Board of oversight obviously give us some pause. But again, the way you all have approached this, I think, will allow us to try to work through this and come up with something. I think it is important that all members of the community that are impacted by this bill be able to say this is right, this is good, and we are behind it.

Mr. SCHUMER. I would just make two other quick points, if I might, and I appreciate the gentleman from Maryland's indulgence on this.

Chairman LEACH. It is not his time.

Mr. SCHUMER. OK. Then I will come back.

Chairman LEACH. You will be granted a full lot of time.

Mr. SCHUMER. If you want, I will come back and ask a second round after the gentleman from Maryland, Mr. Chairman. I can do it either way.

Chairman LEACH. I just meant that I am not taking it out of his 5 minutes. If you do not mind, I will allow an extra minute for the gentleman from New York.

Mr. SCHUMER. Just in reference to the second point, I agree the SEC is a tougher regulator, but it is also a less enveloping regulator. It is a different style.

In other words, you are in a securities firm—it seems to me this is right. I may be wrong about this, never having worked in either one.

You figure out, OK, what are the legal requirements we have to come up with after you decide what you want to do, whereas when

you are in the Fed, there is sort of a feeling I get where they keep whispering to the Fed, what about this, what about that, is this going to be OK, is that going to be OK?

It is a different—as I say, one—I am comfortable in describing the big brother relationship as the Fed relationship, and this one is more adversarial. I think it serves the industry quite well.

I think the Fed relationship serves the banking industry quite well, but I would guess, if some economist, political economist, economic sociologist—call it what you will—would look at the way each of them regulate, it is far more different than even looking at the laws and the regulations and the black-and-white words that we use are there.

The other question I have—and maybe you could answer both—I am also worried that—let us say I am right and you are wrong.

Let us say the structures in the bills—it allows some synergy, but at the larger price of sucking up entrepreneurialism, not immediately but over a period of years. I would not trade our system for a Deutsche Bank system.

I am worried—if I had full faith that new companies could start-up and gain some of the size that is necessary, then they will be fine, and that is the capitalist model, and I would not worry.

I would say OK, big firm X, which used to be a swashbuckler and out there, is now becoming very corporate and very cautious, and new little firm X will rise up and take the place, and we have seen that in the securities industry itself.

You know, 20 years ago, I guess, Salomon Brothers was the bad boy, and now, they are the establishment, and then Bear Stearns and this one and that one get bigger, but I do not have that confidence in the modern world.

Because capital is important, one of the things that is driving us in this direction, while you might end up with boutiques that compete in little areas, you would not have the sort of larger entrepreneurial firms that would be able to come up.

So, I am troubled about that, too.

You know, all the stars are aligned against this view. The banks want to get into this industry. The securities industry basically has given up the fight, for whatever reason.

You know, the major players are either silent or have found their own accommodation, Merrill Lynch being in a different place than some of the more traditional-type firms, but I wonder if we are just not moving too fast and going to, in the—even in the medium-term run, just sacrifice something that is pretty good.

So, I guess my question is what about—what are your thoughts on new firms being able to startup and replace the old ones if my premise is right that those old ones will not be as good once they are part of a big corporate entity?

Mr. LEVITT. I have been around the securities business

Mr. SCHUMER. A lot longer than me.

Mr. LEVITT. Too long not to appreciate the note of caution that you sound. I think it is important that that note be part of your deliberations on this issue. I think your observations about a different style of regulation are certainly correct.

I think a good regulator is able to adapt his style and strategy to the industry and the markets that he regulates. While we may be stern, I think we do not—we try not to micro-manage.

We allow the industry, as much as possible, to try to address issues that we call their attention to, rather than imposing upon them redundant regulation, and I think that trying to see to it that the principles of functional regulation are adhered to is probably the best defense the committee will have in avoiding the problems that you correctly anticipate.

I would be foolish to sit here and say that an industry which is functioning as well as the U.S. securities industry is today does not run some risk when you create a new kind of relationship and a new pattern. I think you have to be very sensitive and very careful, and you put your finger on precisely the thing we have to be careful about, and that is innovation and entrepreneurship. The best way to preserve this is not to handcuff firms with regulators that are not experienced at overseeing them or by regulations that are inappropriate to encouraging the risk-taking that is essential to allow them to function.

Mr. SCHUMER. I am not—just—if I might continue to carry on this dialogue, with the Chairman's permission, I guess I put less stock in the regulatory influence—the regulatory influence is secondary, and it is the other side of the coin of the structure and deposit insurance and all of that, but even if we were to have functional regulation, corporate culture is not determined strictly by regulation.

It is determined—or business culture, the better word—and I think, if the top thinks like a bank or thinks like a corporate entity, which is good—I do not think one is better than the other. I want to see both.

I think America does well when we have both, but if a bank thinks like a corporate entity and the person who is ultimately overseeing the entrepreneurial—either affiliate or subsidiary—thinks that way, over a period of time, even if you have pretty strict functional regulation, that type of thinking will envelope the smaller one, or that is my fear.

So, I do not put—I think functional regulation is important, I agree with it completely, but I do not think, tomorrow, just to use somewhat hyperbolic language, that if you were to turn over some of the parts of banks that are engaged in what should be functionally regulated by the SEC that they would change that much, nor do I think, conversely, that a securities firm that remains regulated by the SEC but was overseen on the day-to-day and minute-to-minute decisions by a different boss is going to keep its culture that much.

Mr. LEVITT. I think that is a risk, but I think that knowing that you have the potential to fail imposes the kind of culture and discipline that cannot possibly be matched with those that know that they are insured against failure.

So, I think that is a protection, but you are quite correct in pointing out the cultural risks that you take in this endeavor.

Chairman LEACH. Well, thank you. Let me end with two or three observations and a couple of more questions, and then we will wrap it up.

First of all, I do not want it to stand that this committee of the U.S. Congress considers any bank unfailable; banks do fail.

Deposit insurance is a protection for depositors, and it does give banks some advantages, but we deal with an industry in which failure is an accepted art form.

In terms of worries—and I think the gentleman from New York is quite prescient with some of his concerns, but my worry is that no bank or securities firm should ever think like a Congress.

Now, having said that, I would like to get one clarification on the record. You have indicated some concerns about the—at the margins, as I read it, of the bill before us, but in the final measure, am I right that you would endorse its basic thrust?

Mr. LEVITT. Yes.

Chairman LEACH. Fair enough.

Second, if I could just ask a final question that relates to current laws as contrasted with proposed law, because it underscores the dilemma and one of the reasons why there is a proposal to change current law, and that question is do you believe that current law permits national banks to conduct securities activities in a subsidiary that are not permissible for the national bank itself?

Mr. LEVITT. I am not a lawyer, but my staff has advised me that it does not. It is a complex area. It is one that I think we have to look at carefully, but my staff's best thinking is that it does not.

Chairman LEACH. Well, the only reason I raise that—I do not want to pit elements of the Federal Government today against each other but to underscore what I think is a case for clarifying the circumstance for the future, and that is, I think, one of the reasons that this legislation is quite timely.

I did ask one of your assistants if she had any questions that she would like to ask you, and she responded with—that she would like to ask if you would like to go home. Let me thank you for coming, sir, and Mr. Becker, as well.

Mr. LEVITT. Thank you.

Chairman LEACH. The committee is recessed until 2 o'clock this afternoon.

[Recess.]

Chairman LEACH. The committee will reconvene, and let me apologize.

We are mid-way in a series of votes, and several have proven to be rather controversial, and so, people are occupied on the floor, but I think it appropriate to begin, and so, as we reconvene to discuss Glass-Steagall, I am very pleased to have the GAO and Mr. Bothwell proceed with the GAO's perspective on the Glass-Steagall bill and also welcome Mr. Gramling and Mr. Swaim.

Do you have separate statements?

Mr. BOTHWELL. No, we just have one statement.

Chairman LEACH. Fine. Please, go ahead, Mr. Bothwell.

STATEMENT OF JAMES L. BOTHWELL, DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY ROBERT M. GRAMLING, DIRECTOR, CORPORATE FINANCIAL AUDITS, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, AND STEPHEN C. SWAIM, ASSISTANT DIRECTOR, FINANCIAL INSTITUTIONS AND MARKETS ISSUES, GENERAL GOVERNMENT DIVISION

Mr. BOTHWELL. Thank you, Mr. Chairman. I have a longer written statement I would like to submit for the record, which I will then summarize.

Chairman LEACH. Please, and without objection, the longer statement will be placed in the record.

Mr. BOTHWELL. Mr. Chairman, we are pleased to be here today to discuss modernizing our financial services regulatory system.

There are many good reasons for considering legislation at this time, and the proposals now before this committee provide a wide range of options for restructuring the traditional relationships between banking, securities, and other related activities.

We believe that enhancing financial sector efficiency is an important public policy goal, but in pursuing that goal, we should not lose sight of other important goals, such as maintaining the safety and soundness of the financial system and of the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers from potential conflicts of interest.

To best ensure achieving all of these goals, we believe any move to modernize regulation of the financial services industry should, number one, provide consolidated and comprehensive supervision of all companies owning federally insured depository institutions, with coordinated, functional regulation of individual components; number two, ensure that capital levels adequately reflect the amount of risk-taking; and number three, ensure that regulatory resources and capabilities keep pace with expanding bank powers and increased linkages between banking and other types of financial or non-financial activity.

We believe that these are fundamental principles that should receive careful attention as Congress considers the best approach for modernizing the financial services regulatory system.

Moving away from a financial services holding company approach or in the direction of allowing commercial or industrial firms to own banks raises particular questions and concerns which suggest that Congress should proceed cautiously.

Mr. Chairman, as you will probably well remember, when Congress last considered expanding bank powers several years ago, the industry was not in very good financial condition.

Many banks had failed or were struggling to restore their capital, and the Bank Insurance Fund was depleted.

We believe Congress chose to follow a prudent course at that time, by seeking first to get the banking industry back in shape.

An important component of this strategy was enacting the FDIC Improvement Act of 1991, or FDICIA.

This Act included a number of provisions to bring the regulatory system in line with the realities of the fast-changing, highly competitive markets within which banks now operate.

These provisions include prompt corrective actions under which regulators are to prevent losses to the Bank Insurance Fund by closing banks before their capital is completely exhausted, as well as various management, regulatory, and accounting reforms designed to strengthen bank controls over risk-taking and to improve the flow of information to regulators and market participants.

While the banking industry is clearly in better financial condition today than it was 5 years ago, in our view it may be premature to assume that fundamental concerns about mismanagement and regulatory supervision have been fully resolved.

Although a credit risk-based capital system has been in place for a number of years and bank capital has increased significantly, much harder-to-measure market and operations risks have become increasingly important for many banking institutions.

Mr. Chairman, I believe that the recent sudden failure of Barings Bank in England really bears this point out quite dramatically. It is very crucial for institutions to have very good controls and oversight of market risk and operations risk.

In addition, while regulators are providing improved guidance for examining risk-management systems, we believe it is too early to tell whether these actions are sufficient for today's challenging environment.

Having adopted interstate banking legislation last year, it is certainly reasonable for Congress to consider regulatory modernization proposals at this time.

At the very least, it seems reasonable to bring the regulatory system up to the point where it gives adequate recognition to the changes that have already taken place in the industry.

Beyond that, we should strive for arrangements that have the flexibility to accommodate further changes without placing safety and soundness, and consumer and taxpayers, at undue risk.

Both the laws governing the financial services industry and the regulatory structure that oversees it were developed for an industry that was compartmentalized into commercial banking, investment banking, and insurance.

Since that structure was set up, basically in the 1930's, these activities have converged to the point where many of the products and services offered by these supposedly different institutions are more similar than different.

Mr. Chairman, in my prepared statement, I go on to explain some of the similarities between commercial banking and investment banking today.

While regulators have adapted to these changes in the industry, they have done so incrementally and on an ad hoc basis.

The result is a regulatory system with overlaps, anomalies, and even some gaps.

For example, certain bank securities activity conducted in affiliates may be examined by both bank and securities regulators in a way that imposes unnecessary burden on the institution.

On the other hand, the capital standards applied to bank trading activity focuses on credit risk, when market or operations risks are equally if not more important, and again, I refer to the Barings incident.

While it may be an opportune time to restructure the laws and regulatory framework governing the financial services industry, we believe that any legislation should include the following four very basic safeguards to avoid undue risk to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers.

First, we believe that financial services holding companies should be subject to comprehensive regulation on both a functional and a consolidated basis.

While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits, an umbrella supervisory authority needs to exist to adequately assess how risk to insured banks may be affected by risks in the other components of the holding company structure.

Thus, we are in agreement with the basic approach taken under H.R. 1062.

Second, we believe that capital standards for both insured banks and financial services holding companies should exist that adequately reflect all major risks, including market and operations risk.

In this regard, we would urge the regulators to try and quickly develop and promulgate capital standards for interest-rate risk, which they are required to do under FDICIA.

Because capital can erode quickly in times of stress, regulators should also be required to conduct periodic assessments of risk-management systems for all the major components of the holding company, as well as for the holding company itself.

Third, we believe that clear rulemaking and supervisory authority should be established that include specific requirements for cooperation and coordination among functional regulators, and the point here is to avoid any overlap or duplication and unnecessary burden on institutions.

Now, fourth and finally, we believe that mechanisms should exist to prevent excessive concentration of economic power and to assure free entry into financial services markets so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

Mr. Chairman, the rest of my prepared statement goes on to elaborate on the reasons why we think each of these four basic safeguards is important.

So, my colleagues and I will be glad to take any questions that you or other members of the committee may have at this time.

[The prepared statement of Mr. James L. Bothwell can be found in the appendix.]

Chairman LEACH. I appreciate your very thoughtful and comprehensive testimony and just so there is no misunderstanding, as you have laid out your concerns, would it be fair to say that you think that the current bill on the table more or less meets the concerned criteria that you have indicated?

Mr. BOTHWELL. Mr. Chairman, I think H.R. 1062 certainly meets most of these criteria. Again, I think that the regulators need to move forward in promulgating some capital standards to reflect interest-rate risk.

They were required to do this under FDICIA of 1991, and I think they were given 2 years to do that, but so far the bank regulators have not been able to reach agreement. So, I think that it is important to have that effort really urged along.

I do not know if you need to write it into the legislation or not, but as the Barings case shows, and as other cases show, market risk and operations risk and interest-rate risk are very significant components of risk in financial institutions these days.

As for the other criteria, H.R. 1062 has the comprehensive consolidated supervisory structure that we recommend, particularly if you have some kind of market-risk capital standard, and I think the mechanisms to prevent undue concentrations of economic power are basically your anti-trust laws. Furthermore, H.R. 1062 does not break down the walls between commerce and banking, so you will not have the concerns there about large commercial firms acquiring large financial institutions under that bill.

Chairman LEACH. Let me ask you, in terms of accounting—I mean the General Accounting Office is obviously a repository of a lot of expertise, and from an accounting standpoint, when you consolidated a subsidiary into its parent, can a parent be insulated from the liabilities of a subsidiary?

Mr. BOTHWELL. Mr. Gramling is our accountant, so I would ask him to answer that question.

Mr. GRAMLING. I will try to. It is a difficult question here with accounting and with legal responsibility.

As a generalization, for a wholly owned subsidiary, which would be evidenced by greater than a 50-percent ownership in that subsidiary, you would consolidate, and I guess the question, then, really goes to is there a point where you would deconsolidate, and if so, what does that mean in terms of responsibility, and we will assume we are talking about losses here.

There are conditions from an accounting standpoint where you would not consolidate to begin with if there was a temporary control or if you had lost control either through a reorganization, bankruptcy proceedings, and so forth.

However, at that point, from an accounting standpoint, any losses incurred are going to roll up to the parent. I think, after that point, it becomes more of a legal consideration, and the lawyers take over in terms of, if you will, piercing the corporate veil.

Chairman LEACH. Mr. Bothwell, you note in your testimony that there have been instances where non-financial firms have attempted to expand into the financial arena and that has not proven too successful.

Some instances were cited this morning where it has been rather successful. What instances would you like to point to where there has not been great success?

Mr. BOTHWELL. Well, I believe that the public accounts show that, in one particular case, the Sears Corp., was trying to make a big move in the financial services area and acquired Dean Witter, All State, and also the Discover card, and I do not believe that they were as successful in those endeavors as they originally expected to be.

So, I think that would be one case where I do not think that the original expectations were really borne out.

Chairman LEACH. Fair enough.

Mr. Barrett.

Mr. BARRETT. I do not have any questions.

Chairman LEACH. Mr. Chrysler.

Mr. CHRYSLER. I do not have any questions.

Chairman LEACH. Mr. LoBiondo.

Mr. LOBIONDO. I do not have any questions.

Chairman LEACH. Let me just pursue a few more questions, then.

Your testimony supports the precept of an umbrella regulator. I assume by that that the Fed would be an appropriate umbrella regulator.

Mr. BOTHWELL. Well, I believe that the Fed would be a logical candidate, at least for the largest financial holding companies. They have experience supervising holding companies under the Bank Holding Company Act, as well as they have the responsibility for maintaining financial stability.

So, I think they have both the experience and the responsibility that makes them a logical candidate.

However, beyond that, there could be other options that Congress may wish to consider. For smaller institutions, you may consider making the lead regulator of the component firm responsible for the holding company supervision, as well.

If, indeed, you had a large securities firm that was affiliated with a much smaller bank, then perhaps it would make some sense to have the SEC and the NASD supervise the holding company, as well.

I think you would want some mechanism there to have common rules, so you have some kind of basic level playing field.

Another possible approach is to have an inter-agency counsel set some common rules for holding companies.

Whatever approach is taken, we do think it is very crucial that someone have an overall look at the entire corporation, including everything under that holding company structure. If you just look at the individual components and rely on firewalls and capital standards, in times of stress, those firewalls could melt and capital could very quickly erode on you, and you could have a very significant risk to the insurance fund.

So, we think it is important to have an umbrella supervisor, and the Fed, I think, is a very logical candidate, at least for the very large organizations.

Chairman LEACH. Well, some firms, both in banking and in the securities industry, have expressed concerns about this umbrella regulator approach. Do you find any legitimacy to their complaints, or do you feel that this is one of the requirements they simply must put up with?

Mr. BOTHWELL. They are objecting to any——

Chairman LEACH. Umbrella regulator.

Mr. BOTHWELL. Any umbrella regulator, not just the Federal Reserve?

Chairman LEACH. Yes.

Mr. BOTHWELL. Well, I would say that there is always the option not to affiliate with an insured financial institution. So, there is al-

ways an option to conduct business where you do not have that affiliation and you would not have that umbrella regulator present.

I would say, if the business choice is to affiliate with a federally insured financial institution, then perhaps one of the costs of that business choice is to have overall consolidated supervision.

Chairman LEACH. As a general rule of thumb, if new activities such as securities activities are to be permitted for insured financial institutions, your preference would be to have those activities conducted through a holding company structure rather than a subsidiary. Is that correct?

Mr. BOTHWELL. Yes. The risk to the insured deposits would probably be greater if you allowed a securities firm to be a subsidiary of a bank rather than being an affiliate under a holding company structure.

That is not to say that there is not any risk to the insured deposits through the holding-company structure. I think there is.

Any losses could go through the holding company to the bank, but I think that is less likely for a given incident in a holding-company structure than it is if you had a securities firm as a subsidiary of an insured bank directly.

Now, some may argue that, as well as greater risk, there are also greater benefits, and there could be. Although from the consumer's perspective, I do not see how the benefits would be any greater to a consumer if a securities affiliate came through the holding-company structure as opposed to the subsidiary of a bank.

So, from the consumer's point of view, I do not see how they would be losing any benefits.

For the bank—if the securities subsidiary was profitable, making money, then those profits would perhaps roll up to the bank.

Well, they would roll up to the bank through the consolidated statements, but on the other hand, if they were unprofitable, incurred losses, they would roll up, as well.

Chairman LEACH. Finally, before I ask others if they have questions, is it your view that either a subsidiary or an affiliate under a holding-company structure engaged in securities activities should come under the SEC functional regulation and mark-to-market accounting precepts? Would you agree with that or disagree?

Mr. BOTHWELL. We agree with that, Mr. Chairman.

Chairman LEACH. Fair enough.

Is there anyone else that wants to ask questions at this time?

[No response.]

Chairman LEACH. If there are no more further questions, thank you very much, and I will say I am sorry there is not more attendance, but your testimony will stand in the record and will be a very important part of it. I personally want to thank the GAO for not only the preparation that went into this statement but for a number of years of testimony on this and related subjects in the financial services arena.

Thank you.

Mr. BOTHWELL. Thank you very much, Mr. Chairman.

Chairman LEACH. The committee is adjourned.

[Whereupon, at 2:44 p.m., the hearing was adjourned.]

APPENDIX

March 7, 1995

TESTIMONY OF

RICHARD ROBERTS

On Behalf of

THE AMERICAN BANKERS ASSOCIATION

Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

U. S. HOUSE OF REPRESENTATIVES

March 7, 1995

TESTIMONY OF RICHARD ROBERTS

Before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 7, 1995

Mr. Chairman, I am Richard Roberts, Executive Vice President and Treasurer of Wachovia Corporation headquartered in Winston-Salem, North Carolina and Atlanta, Georgia. Wachovia is the parent bank holding company of three nationally chartered banks. I am also Chairman of the Board of the newly-established ABA Securities Association (ABASA). The ABASA is an affiliate of the American Bankers Association (ABA) created to represent the interests of banking organizations in the securities area. The ABA is the only national trade and professional association representing the entire banking industry, from the smallest banks to the largest bank holding companies. ABA members represent about 90 percent of the total assets of the banking industry. Approximately 94 percent of ABA members are community banks with assets less than $500 million.

Mr. Chairman, I commend you for holding this important series of hearings, and for your leadership in providing a forum for discussion of the urgent need for financial modernization. I also commend you for your bill and the improvements made in the new version of that bill. Because of your efforts at the very beginning of this Congress, there is now a real opportunity to finally enact reform legislation. I thank you for this opportunity to present our views on financial restructuring.

Bank involvement in securities activities and other financial services has been the subject of debate for many years. Although Congress has not yet acted, the marketplace has not stood still. In fact, the financial services industry has undergone some very dramatic and fundamental changes over the past decade. But Mr. Chairman, as Al Jolson said, "You ain't seen nothing yet, folks." The changes that will be forthcoming over the next few years, particularly in the telecommunications area, will dwarf what has taken place so far. There is no doubt that our regulatory structure -- constructed decades

before megabytes, CD ROMs, digital communications, and fiber optics -- must be modernized.

As a banker, I can tell you that finding ways to compete effectively in today's market without running headlong into banking's out-dated regulatory framework is no easy task -- and it is absorbing a considerable amount of the time, energy and resources of large and small banks across the country. Clearly, the time has come to take constructive action to bring our financial system up to date.

Bankers are not alone in supporting financial reform -- many members of the broader financial services industry also recognize that the existing structure makes our financial firms less efficient. And last week, at this Committee's hearing, the federal banking regulators reiterated their support for financial modernization, and the Administration also came forward in support of reform.

We must design a financial framework that:

- allows banks and banking organizations to offer a broader array of products and services, and promotes free and fair competition among different sizes and types of firms;

- is flexible enough to adjust to changing customer demands, market conditions and technological advances;

- provides adequate protections to ensure the safety and soundness of the system without adding unnecessary costs; and

- provides consistent regulation by function, treating all financial service providers equally regardless of structural entity.

Mr. Chairman, we realize that this is a tall order. But with your leadership, we look forward to a constructive debate on the issues. We can and we must build on this consensus to make the legal and regulatory changes necessary to allow our financial system to move into the next century.

The Changing Market for Financial Services

Time travelers from the 1960s would have trouble recognizing today's financial services industry. Today, consumers are as likely to use a money market fund as they are to use a bank checking account; AT&T is a major issuer of consumer credit cards; home buyers can get a mortgage from General Motors; and the list of non-traditional suppliers of financial services gets longer every day.

Just last month, the American Automobile Association -- a national car club -- announced its intention to form a financial services company that will own an FDIC-insured banking institution. They intend to offer personal credit lines, travel loans, vehicle financing, mortgage loans and home equity loans. AAA already has an affinity credit card program that has issued 3.8 million cards, and is the largest single seller of American Express travelers checks ($2.5 billion annually).

Because these non-bank providers of financial services do not operate under the same constraints as banks, affiliations between securities firms, insurance companies, and real estate brokerage firms are common. Many of these firms also own FDIC-insured savings institutions -- and many firms, ranging from Aetna Life and Casualty Company to J.C. Penney, also own so-called "non-bank" banks. As Table 1 clearly shows, in today's market, the line between banking firms and other financial firms exists only in theory -- in practice, it has been overrun by market forces.

For example, look at the breadth and depth of the financial activities of the largest securities firm in the country, Merrill Lynch (total assets of $153 billion):

- Merrill Lynch owns Merrill Lynch Bank and Trust Company, an FDIC-insured bank with $1.7 billion in assets -- larger than 97 percent of the banks in the country. Merrill Lynch offers FDIC-insured deposits; a complete range of securities services including underwriting and brokerage; options, commodities, and financial futures contracts; money market funds and mutual funds; cash management services for both businesses and consumers; retirement account management; debit/credit cards; retail and corporate lending; and underwriting and sales of life insurance and annuities. In 1993, Merrill Lynch had an underwriting volume of $193 billion; held private client assets of $536 billion; originated about $1.5 billion in mortgages; made about $1.6 billion in home equity loans; held more retirement plan assets than the top 140 commercial banks

combined; had more than 400,000 small business accounts with over $105 billion in assets and $960 million in loan commitments to small and mid-sized businesses. Recently, Merrill Lynch launched a direct lending program for their large corporate customers, allowing them to provide their corporate clients with a full menu of funding options ranging from equities to a variety of long- and short-term debt instruments.

It is clear, however, that not all firms would choose to diversify even if the laws barring affiliations between banks and other financial firms were changed. The important point is that banking organizations should have the option to enter other lines of business. Whether they do so or not is a business judgement that each individual institution should be free to make. It simply makes no sense to prohibit activities that banking institutions could and should provide to meet the needs of their customers.

Financial Modernization Will Benefit Consumers

The growing integration of financial markets offers many opportunities to improve the efficiency of production and delivery of financial services. For example, removing Glass-Steagall restrictions and allowing banks of all sizes to offer securities services would certainly help banks provide economic benefits to a wide range of their customers -- including consumers, state and local governments, and businesses.

For example, state and local taxpayers would realize significant cost savings if banks were allowed to underwrite and deal in municipal revenue bonds, as provided in Chairman Leach's bill. Increased competition in the municipal market would reduce costs for all issuers, and would offer small municipalities an important option for financing needed community infrastructure improvements. Local banks already provide a wide range of financial services to their communities -- they clearly have the knowledge and the expertise necessary to underwrite revenue bonds. But Glass-Steagall prohibits them from performing this service, resulting in less competitive municipal bond markets, and leaving many small communities with fewer financial choices.

Allowing banking organizations to underwrite corporate debt and equities would provide similar benefits to businesses. More underwriters means more competition -- and more competition means more choices and lower prices. Corporate securities underwriting markets are today quite concentrated -- the five largest underwriters of

corporate debt control about 65 percent of the market, and the five largest underwriters of common stock account for half the market.

In many cases, smaller businesses do not have the same access to securities services that is available to larger businesses. Similarly, customers in less populated areas do not have access to securities services that is available to businesses in metropolitan areas. Because of their local presence, banking organizations are likely to extend the reach of securities markets to small and regional businesses for whom such financing options may not now be available. Building on existing relationships with their business customers, banking institutions could extend underwriting and market-making services to small and mid-sized businesses, giving them access to capital markets. Since lack of access to capital is among the most serious problems facing many businesses large and small, participation in corporate debt and equity markets is likely to be particularly beneficial.

Mr. Chairman, as I mentioned at the outset of my statement, 94 percent of ABA's members are community banks, and any Glass-Steagall reform bill must carefully consider their needs. While community banks may not want to underwrite, they badly need the flexibility to offer retail securities services in a regulatory structure that is compatible with how they do business. Today, when a customer withdraws funds from a bank and places those funds with a securities firm, the bank not only loses the funds, but may also lose the customer. That community bank may never have the opportunity to work with that customer again, to put his or her funds back into the community. Mr. Chairman, we know that you are a long-time supporter of community banking, and that your effort is designed to support community banking. We may have some further suggestions on fine-tuning your bill in that regard.

Implications for International Competitiveness

As technology pulls markets around the world closer together, competition from foreign financial institutions in both global and domestic markets is intensifying. International competitive pressures have sparked a wave of regulatory reforms in other industrialized countries, giving foreign financial markets and institutions a head start in developing innovative services to meet the needs of the future. The greater their head start, the harder it will be for our institutions to catch up.

Losing our competitive edge in international financial markets has serious implications for the U.S. economy. The effects go beyond jobs and productivity in the financial sector -- losing our financial leadership will have an impact on the competitiveness and market share of other U.S. industries as well, especially export-oriented industries. It is sometimes argued that money owes no national allegiance and that U.S. firms will have the same access to credit whether they are dealing with U.S. banks or foreign banks. However, we live in an imperfect world and the market does not always operate according to text book principles. Many governments look upon their banks as an integral part of their long-term export promotion strategy. The U.S. will face an up-hill battle to remain a leading player in the global economy if its banks are being swept aside in the competitive arena.

Glass-Steagall Restrictions on Bank Securities Activities Are Unnecessary

The historical importance of Glass-Steagall restrictions is shrouded in legend and myth. The truth is that the Glass-Steagall provisions were only one small part of the government's overall response to risk in the financial system in 1933. A closer look shows that Glass-Steagall was not crucial to the government program addressing problems in the securities and banking industries in 1933, nor is it necessary today.

The Banking Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934 were the basic government responses to the crises in the stock market and the banking system. The most important provisions of the Banking Act of 1933 included the creation of the Federal Deposit Insurance Corporation (FDIC); the creation of the statutory basis for the Federal Reserve Open Market Committee; increased minimum capital for national and member banks; restrictions on extensions of credit by member banks to their affiliates (Sec. 23A of the Federal Reserve Act); and restrictions on the use of the credit facilities of the Federal Reserve for purposes of speculating in securities and real estate.

The Securities Act of 1933 and the Securities Exchange Act of 1934 made fundamental changes in the supervision of public offerings of securities and the regulation of securities markets. Those laws established the SEC; required federal regulation of public offerings of securities; prohibited fraudulent, manipulative or deceptive practices; required federal registration of broker-dealers; and mandated a host of other protections to the public from unscrupulous market participants.

These changes to the banking and securities laws served to stabilize financial markets in the 1930s and are the basis for today's regulation of the banking and securities business.

In comparison, the Glass-Steagall provisions *were not* crucial to restoring stability to the financial markets in the 1930s because the activities they addressed were not the cause of either the stock market collapse or the collapse of the banking system in the 1930s.

A closer look at the facts shows that there is no truth to the myths about the importance of Glass-Steagall.

- **Securities activities of commercial banks and their affiliates were not a significant cause of the collapse of the banking system in the 1930s.** There is no credible evidence, even in the hearings that were held at that time, that banks with securities affiliates failed because of the activities of those securities affiliates. In fact, banks with securities affiliates survived the difficult times of that period better than those without such affiliates. The overwhelming number of banks which failed were small rural banks that did not underwrite securities.

- **The Glass-Steagall provisions in the Banking Act of 1933 were added because Senator Glass believed in a banking doctrine which is now irrelevant.** Senator Glass believed that the only safe function of commercial banks was to make short-term, self-liquidating loans to support commercial firms in commercial transactions -- the "real bills doctrine". Adhering to this belief, Senator Glass viewed loans to brokers as unproductive, and he attempted a number of times to pass legislation to make it difficult for banks to provide such credit. He succeeded only when hearings in Congress produced evidence which (in the drama of the times) was sensationalized and produced an atmosphere conducive to passage. The real bills doctrine has since been discredited, and certainly can not be used to defend Glass-Steagall in today's world.

- **Even the Glass-Steagall Act does not mandate a total separation of commercial and investment banking.** A common error is to describe the Glass-Steagall Act as prohibiting commercial banks from underwriting or dealing in all securities. That is simply wrong. Glass-Steagall explicitly allows banks to underwrite and/or deal in securities such as Treasuries and general obligation

bonds. (At the time Glass-Steagall was passed, municipal revenue bonds did not exist, so these instruments were not addressed in the legislation.) In recent years, courts have also held that Glass-Steagall does not prohibit banks or their affiliates from engaging in retail securities brokerage and a significant range of securities underwriting activities.

Protecting Safety and Soundness

Certainly, any policy which expands the products and services banking institutions may offer must consider the impact on the safety and soundness of the commercial bank and any potential risk to the deposit insurance fund. Several points are related to this discussion. First, there is a significant history of bank involvement in other financial services, including securities. That history shows that these additional activities have not raised the risk profile of the banking institution; in fact, these activities have *lowered* the risk profile. Second, the greatest risk is to do nothing -- a banking industry prevented from competing by out-of-date laws cannot truly be a sound system. Third, there are already strong safeguards in place. And fourth, there is little point in providing banking institutions with new authorities with one hand, and then, with the other hand, imposing regulatory restrictions which prevent those institutions from using the authorities efficiently and competitively.

Let me elaborate on these points. First, U.S. banks are currently allowed to underwrite certain securities within the bank, and recently some banking organizations have been authorized to conduct broad securities activities through holding company affiliates (so-called Section 20 subsidiaries). Foreign banks have engaged in securities and insurance activities for years, and many U.S. banking companies have securities operations overseas. There is no evidence that any of these activities is inherently riskier than traditional banking activities, nor that the combination of banking with these other financial activities raises the risk profile of the banking organization. In fact, there is good reason to believe that diversification of activities may actually contribute to greater depository institution stability.

Second, it is now widely documented that traditional banking is steadily losing market share. It is noteworthy that banking organizations' stock continues to sell at price/earnings ratios significantly below market norms despite the industry's recent record earnings. In other words, the market perceives banking as a declining industry. In the long-run, a declining banking industry -- an industry which is unable to compete because

of out-of-date laws -- can not truly be strong and sound, and can not support economic growth. Again, the greatest risk to safety and soundness is to do nothing.

Third, there are extensive regulations already in place to protect against any potential problems that may arise between an insured depository and an affiliated entity. Over the past fifty years, a highly sophisticated regulatory regime has been developed to govern the activities of banks, bank holding companies, and securities firms. These include Sections 23A and 23B of the Federal Reserve Act and Section 106(b) of the Bank Holding Company Act Amendments of 1970 which deal specifically with transactions between a bank and its affiliates, plus extensive prudential regulations imposed on both banks and securities firms.

Sections 23A and 23B of the Federal Reserve Act place strict limits on the terms and conditions of credit extensions and other transactions between banks and their affiliates. Section 23A restricts loans to one affiliate to 10 percent of the bank's capital and surplus (20 percent of capital and surplus for all affiliates), and requires that all transactions be fully secured and consistent with safe and sound banking practice. Section 23B requires that all transactions, including purchases and sales of assets, between a bank and its affiliate be "arms length"; that is, that the terms and conditions of the transaction must reflect prevailing market conditions. The restrictions in Sections 23A and 23B reach transactions with third parties that would benefit a bank's affiliate. Taken together, Sections 23A and 23B insulate banks from their affiliates and effectively restrict harmful loan and securities transactions between banks and their affiliates.

Banks, like all other businesses, are subject to the anti-tying rules of the antitrust laws. But banks are also subject to a special, much more restrictive law. Section 106(b) of the Bank Holding Company Act Amendments of 1970 eliminates any possibility that banks and their affiliates might enter into improper "tying" arrangements. Section 106(b) makes it illegal for banks to condition the availability of one service on the purchase of another, even though the bank may not have any "market power" over the service. In fact, section 106 (b) is so tight that it has severely restricted the competitiveness of banking organization in some cases.

In addition to these regulatory restrictions dealing specifically with inter-affiliate transactions, there is also a whole body of banking and securities laws and regulations which deal with prudential operation of covered institutions. For example, the banking industry is subject to a comprehensive network of state and federal regulations dealing

with capital adequacy and safe and sound operating procedures, extensive reporting requirements, and thorough examination and supervision. FDICIA gave the FDIC authority to impose additional bank capital requirements for non-traditional activities if such action is necessary. The Securities Exchange Commission and the self-regulatory agencies, such as the National Association of Securities Dealers, impose a series of financial adequacy regulations, conduct standards, and reporting and examination requirements on securities firms.

Some of the recent discussion about risk to the fund from additional activities totally ignores the significant changes in law that have already taken place to reduce the risk of loss to the deposit insurance fund. A number of provisions in FDICIA -- particularly the timing of intervention in troubled institutions, the treatment of failed banks, and limitations on the so-called too-big-to-fail doctrine -- combined with the depositor preference statute, have significantly reduced potential losses to the insurance fund. A white paper on this subject is being prepared for ABA by former FDIC Chairman Robert Barnett, which we will make available to the Committee.

Fourth, so-called firewalls that prevent banking institutions from competing effectively will undermine the very purpose of modernization. As already noted, many companies, including some of the largest in the country, already offer virtually all financial services --- including traditional banking services -- basically without any firewalls. It is these companies that banking organizations must compete with on a daily basis. Often, calls for firewalls by some of banking's competitors are nothing more than calls for protection from competition.

We commend you, Mr. Chairman, for the flexibility you have sought to build into your bill and for the improvements in the new version of the bill. It is critical that regulators be given flexibility to adjust to changes in circumstances. Otherwise, the banking industry may find itself locked into a regulatory restriction for years even if virtually everyone agrees that it is undermining bank competitiveness and that the particular restriction should be modified. History shows us that having to come back to Congress for fine-tuning is just not workable.

Revenue Bonds

I particularly want to support the provision in H.R. 1062 which permits banks to underwrite revenue bonds. This is very important to my bank, as well as to many others. It will enable bankers to better serve our communities and result in lower financing costs -- and that is good for taxpayers. The fact that this change has not been made sooner is a prime example of the need for flexibility in our laws. Glass-Steagall allows banks to underwrite general obligation bonds. Banks have done this successfully and without any safety and soundness problems. Revenue bond underwriting, which is virtually the same thing, was not permitted under Glass-Steagall only because those types of bonds were used so sparingly in the 1930s that the authors of the Glass-Steagall Act were not aware of them. Over time, revenue bonds have grown in importance; but since only Congress could change the law, and since it was in the interest of the securities industry to block competition, banks continue to be shut out of that market sixty years later -- to the detriment of communities across the country.

I would suggest, however, that this provision be revised to permit banking organizations to participate in national selling syndicates. As you know, these syndicates are put together for large attractively-priced issuances of state and local obligations.

Services of a Financial Nature

We also strongly support the provision in the legislation permitting bank holding companies to engage in services of a financial nature. This is an important change from the current "closely related to banking" test. Again, flexibility is the key here. Regulators must have the flexibility to adjust permissible activities to the rapidly changing market place. The "closely related" test has proven to be overly restrictive, and will become even more so over time, primarily because it is sometimes read to imply that there must be some direct connection to what banks have traditionally done.

Legislative Process

In view of the past history of financial reform legislation, we feel compelled to make one further point. In the last Congress, with the leadership of many members of this Committee, interstate banking reform was enacted. But it was only enacted because it was kept clean of restrictive amendments and additional regulatory burdens. We

strongly believe the same approach must apply here. The ABA will strongly oppose any legislation which contains additional restrictions on the current authorities of banking institutions -- in the insurance area, for example -- or new regulatory costs, such as additional "consumer" laws. With all the changes occurring in the market place, banking can not afford any new restrictions or regulatory costs not applicable to our competitors.

Conclusion

Banks and other financial services firms are working every day to keep up with customers' demands. But there is little doubt that for banks, the process of adapting to today's marketplace is far more difficult -- and far less efficient -- than is necessary because of woefully out-of-date laws. And this means that consumers of financial services are being short-changed.

Mr. Chairman, we are ready to work with you and the members of this Committee, the Congress, the regulators, the Administration, and other members of the financial services industry to design a financial framework based on today's marketplace, not that of the 1930s. Such a system will provide financial consumers with more and better products at lower cost, and will make the economy stronger and more resilient. I thank you, Mr. Chairman, for this opportunity to share our views with the Committee. I will be glad to answer any questions you and your colleagues may have.

Firms	FDIC Insured Depository	Consumer Loans	Credit/ Debit Cards	Mortgage Banking	Commercial Lending	Mutual Funds	Securities	Insurance
Ford	✓	✓	✓	✓	✓		✓	✓
General Motors	✓	✓	✓	✓	✓			✓
General Electric	✓	✓	✓	✓	✓	✓	✓	✓
Prudential	✓	✓	✓	✓	✓	✓	✓	✓
John Hancock	✓	✓	✓	✓	✓	✓	✓	✓
American Express	✓	✓	✓	✓	✓	✓	✓	✓
Travelers	✓	✓	✓	✓	✓	✓	✓	✓
Beneficial Corp.	✓	✓	✓	✓	✓	✓	✓	✓
Transamerica		✓	✓	✓	✓	✓	✓	✓
Merrill Lynch	✓	✓	✓	✓	✓	✓	✓	✓

TESTIMONY

of

RICHARD L. MOUNT
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SARATOGA NATIONAL BANK
SARATOGA, CALIFORNIA

on behalf of the

THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

on

THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

before the

COMMITTEE ON BANKING AND FINANCIAL SERVICES

of the

UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 7, 1995

Mr. Chairman, I am Richard L. Mount, the President and CEO of the Saratoga National Bank, a $78 million community bank located in Saratoga, California. I am also President of the Independent Bankers Association of America (IBAA). The IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

We appreciate this opportunity to testify on the issues of Glass-Steagall Act and Bank Holding Company Act reform proposals. Both of these Acts have been cornerstones in maintaining the safety and soundness of our banking system, prohibiting undue financial concentration, and protecting the integrity of the deposit insurance fund.

These legislative foundations helped create our remarkably diverse financial services industry, which in turn supports the strongest small business structure in the world. We hear too much that we should change our existing system to mirror the Japanese, British or German system. I do not understand this type of inferiority complex thinking. We have the strongest, the best, the most resilient financial system in the world. When you legislate changes you must be convinced that they are for the betterment of all of America, and not just for the betterment of Wall Street and for those few banks that compete globally. I also note that Germany currently is critically reviewing its financial structure, particularly the role of universal banks in this structure.

There are several important banking issues that this Congress will face this year, including the havoc that undisciplined derivatives activities are causing domestically and internationally, the capitalization of the SAIF and the payment of the FICO bonds, and the reform of the Federal Home Loan Bank System.

These items should be receiving a higher priority than the repeal of the Glass-Steagall Act, which is an issue without any popular constituency and which is being driven by a relative handful of large financial players. I would like to think that a benevolent God was passing all of us a message when the venerable Barings Bank failed a few days before Secretary Rubin unveiled the Treasury proposal for repealing Glass-Steagall. The Treasury proposal would provide the legal framework for the massive consolidation of our financial services industry. If I were one of the large financial players I would also be advocating repeal of Glass-Steagall -- repeal would increase my market share and power.

Our main caution with regard to Glass-Steagall Act reform would be -- do it right and know what you are doing. The Leach bill comes the closest to meeting this test. Otherwise, future Congresses will have to deal with the mess that you created. And as you know, we are still digging out from the abysmal public policy decisions that led to the S & L debacle and cost the American taxpayer more than $150 billion.

GENERAL BACKGROUND

The Glass-Steagall Act was enacted as part of the Banking Act of 1933. It was part of the protections that were put into place to prevent a recurrence of the systemic collapse of the banking system which led President Roosevelt to declare a bank holiday in 1933. The purpose of Glass-Steagall was to limit the securities activities of banks because of the following potential hazards:

1. The association of a bank and securities firm could impair public confidence in the bank if the latter performed poorly;
2. The bank might be tempted to make unsound loans to its securities affiliate or to companies whose securities it was underwriting.
3. Bank customer goodwill could suffer if any customer suffered losses after investing in securities offered by the bank.
4. The bank may make unsound loans in order to facilitate the sale of securities in which the bank or its affiliate dealt.
5. The affiliate could dump poor issues into the bank's trust department.
6. The bank's promotional interest in the securities would be in direct conflict with its obligation to render impartial advice.

With the Glass-Steagall Act protections, safety and soundness issues still come to the forefront. The potential for large and unexpected losses in an investment bank is a fact of life today. The Barings investment bank is a recent example. Barings was the oldest investment bank in Great Britain, over 200 years old. It was also said to be one of the most conservatively run investment banks in the country. Yet, over the course of only one month a single trader in its Singapore office was able to rack up losses that would appear to exceed Barings' capital by $1 billion. And the potential conflict-of-interest problems noted by the Supreme Court on the Camp decision are still valid today.

The Bank Holding Company Act prohibits the mixing of banking and commerce. The restrictions were first established in the Bank Holding Company Act of 1956, and they were amended and expanded in the 1966 and 1970 amendments to the Act. The restrictions were enacted because Congress felt that otherwise there would be consolidation in the industry that would lead to monopolization, and huge banking and industrial complexes would be created if bars were not put into place.

These issues have not changed over the years. There is still the potential for conflicts of interest when banking and non-banking firms affiliate. Maintaining the wall between banking and commerce is critical to the free enterprise system. Our system relies on banks to allocate credit to its most productive uses. Separating banking and commerce insures that credit is allocated impartially and without conflicts of interest. Breaching that wall raises the risk that credit decisions will be based on the business strategies of the bank's corporate parent and not on economic merit.

If banks were allowed to affiliate with commercial and industrial firms, they would enjoy an unfair advantage over other banks and over commercial firms not associated with a bank. Cross selling of services is very important in companies with multiple arms. Banks, subject to the Bank Holding Company Act, can only engage in activities closely related to banking. By contrast, if diversified firms owned banks, they would be free to combine banking with a wide variety of financial or other services. Former FDIC Chairman William Seidman testified before the Senate Banking Committee that the non-bank bank loophole, which breaches the wall between banking and commerce, "is highly inequitable and detrimental. Allowed to grow, nonbank banks can weaken the real banks by competing in an unfair contest in the market place." (S. Rep. 100-19, 100th Cong. 1st Sess., March 19, 1987, pg. 9)(emphasis added).

Breaching the banking and commerce wall also undermines bank supervision by threatening the safety and soundness of our financial system. There is no practical way to separate a bank from its affiliates, either operationally or in the public's perception. Federal Reserve Board Chairman Alan Greenspan testified about his concerns with the efficacy of firewalls when he testified before this committee on February 28, 1995. He warned against placing too much faith on firewalls, because "under stress, they tend to melt." This testimony was similar to testimony by then Federal Reserve Board Chairman Paul Volcker throughout the 1980s. For example, he testified before the Senate Banking Committee that "problems in one part of the system will inevitably be transmitted to other parts." (S. Rep. 100-19, 100th Cong. 1st Sess., March 19, 1987, pg. 9) (emphasis added).

Firewalls meant to protect the insured bank from the risk associated with securities, commercial and industrial affiliates will not work in an emergency. As history shows, in the case of a conflagration, firewalls will burn very quickly. One only has to look back a few years to Continental Illinois and its First Options affiliate. Although firewalls were in place, when First Options suffered massive losses, Continental Illinois National Bank stepped in and improperly loaned money to First Options to prop it up. Although the loan was quickly upstreamed to the holding company, and the bank suffered no loss that time, what occurred shows how useless firewalls are.

CURRENT REFORM PROPOSALS

There are three proposals on the table at the present time. In summary, they would amend the Glass-Steagall Act and the Bank Holding Company Act in the following ways.

CONGRESSMAN BAKER'S PROPOSAL

The broadest proposal is the one put forth by Congressman Baker (H.R. 814). This proposed legal structure would permit a holding company to own a major bank, a major securities firm, and a major industrial firm. Such a concentration of economic and financial power is almost unAmerican, and we strongly oppose it.

The bill contains some firewalls which would restrict transactions between the two entities. However, these firewalls are minimal, and essentially restrict the commercial bank from extending credit or guarantees to the investment bank, purchasing assets from the investment bank, or extending credit to an investment company affiliated with the investment bank.

The Bank Holding Company Act would effectively be repealed by the bill. In addition to allowing affiliations between commercial banks and investment banks, affiliations would also be allowed between commercial banks and any other entity. Thus Ford Motors, Prudential Insurance, Merrill Lynch, and Chase Manhattan Bank could be commonly owned. And this entity would have an unregulated holding company directing it, with no minimum capital requirements imposed on it. There would be no firewalls between the commercial bank and the non-investment bank affiliates other than Sections 23A and 23B of the Federal Reserve Act, which essentially requires only that transactions among a commercial bank and its affiliates be at an arms length, and that asset transfers be completed at market value.

Breaching the banking and commerce wall in the Bank Holding Company Act in this manner will allow for the possibility of systemic risk that Congress should not allow. To begin with, the source of strength doctrine is thrown out the window because the holding company would not be a bank holding company and would have no minimum capital requirements. The source-of-strength doctrine recognizes the effect of Federal deposit insurance and the implicit taxpayer guarantee that stands behind it, and provides for the resources of non-insured entities that choose to affiliate with an insured bank to be available to support the bank. This important principle must be maintained.

The risks inherent in commerce are great. An insured bank should not be put at risk because of affiliations with such companies. The market sees a holding company and its subsidiaries as component parts of a whole that are interrelated and draw strength from each other. In fact, if this were not so, there would be no reason to affiliate these entities under a common shell. If the market views the holding company and its subsidiaries as an integrated entity, then problems in one subsidiary will necessarily be transmitted to other parts of the holding company, including the insured bank.

Insurance underwriting brings with it some very large risks. These companies engage in financial services that are the same or similar to those offered by commercial and investment banks, along with the underwriting of insurance. They also are direct investors in and developers of real estate. Yet insurance companies are not Federally regulated. Thus, although the Baker approach extols the virtues of functional regulation, it exempts from any Federal regulation an industry that can engage in a wide range of financial services and in real estate activities that have proved fatal to many Federally insured institutions. This Committee should be most careful indeed in putting haphazardly regulated financial entities together in a common structure, particularly in light of the concerns Chairman Greenspan has raised about the efficacy of firewalls.

Competitive issues are also raised. Our financial system relies on banks to allocate credit in an impartial manner to creditworthy entities. The separation of banking and commerce helps to insure that the credit-making decision is not tainted due to a conflict of interest. To tear down the walls raises the risk that credit decisions will be made on the basis of strategic decisions regarding the business of the holding company and its affiliates, and not on the creditworthiness of the borrower or the economic merit behind the request for the credit. There is also a possibility that credit will be more readily available to affiliates of the bank than to non-affiliates. A business with a guaranteed line of credit has a substantial advantage over one that does not. If this advantage is caused by an affiliation, rather than merit, it is unfair and undermines the basic tenets of the free market system.

Finally, the fact that functional regulation will be applied, and the Federal Reserve Board will not regulate the holding company, raises safety and soundness issues. In the Drexel Burnham case, the holding company maintained adequate capital in the regulated broker-dealer subsidiary. Losses occurred in other subsidiaries, and "excess" capital in the broker-dealer was used to support those troubled subsidiaries. Ultimately, even though the broker-dealer remained adequately capitalized, the losses and the lack of public confidence in the entire entity brought down the entire holding company. The functional regulation in the Drexel Burnham case was no substitute for having a regulator supervise the entire entity. Such supervision puts an overall picture of the financial condition in the hands of one regulator, and allows for early action with regard to the entire holding company if problems begin to arise. This is especially important in the context of an insured bank.

THE ADMINISTRATION PROPOSAL

On February 27, Secretary of the Treasury Robert Rubin unveiled the outlines of the Administration's proposal to reform the Glass-Steagall Act and the Bank Holding Company Act. It would appear that the administration would allow the affiliation of commercial banks, investment banks and any other "financial" company, including insurance underwriters. These entities could be affiliated either in a holding company structure or as a parent-sub arrangement with the bank as the parent.

This proposal causes us great concern, and we strongly oppose it. First, it allows an insurance underwriter to be affiliated with a bank. Insurance companies are major competitors of banks with regard to commercial loans. Additionally, insurance companies have large investments in all types of securities and derivatives, a potentially volatile situation. Insurance companies are also heavily engaged in real estate development. We do not have to think very hard to remember the $150 billion that taxpayers have had to pay, in large part because insured institutions were allowed to become involved in real estate development. Furthermore, as noted above, insurance underwriters are not Federally regulated.

The ability of the bank to hold securities and insurance affiliates as a subsidiary is also fraught with danger. The closer together these companies are, the more they will be identified by the public as a common entity. This increases the risk that the public will perceive problems in the subsidiary as being problems in the parent bank. This could lead to runs or other financial problems for an otherwise healthy commercial bank.

One of the reasons given for allowing banks to be affiliated with other financial companies is that cross-marketing and joint-marketing of products and services is more efficient. More efficient it may be, but it raises the likely prospect of customer confusion over whether a product is or is not FDIC insured. It also gives large integrated companies an unfair competitive advantage over independent banks. In an integrated company, a customer would be able to receive banking, insurance, and securities products all at one time. Although tying of the products is prohibited, the ability to market them as a package will exist. Banks that are not affiliated with insurance and securities companies would have great trouble competing with such companies. And the simple fact is that small banks do not have the resources to purchase such companies, and they are too small to be desirable acquisitions by insurance or securities firms. Thus they are effectively frozen out of the market.

CHAIRMAN LEACH'S PROPOSAL

Chairman Leach has introduced H.R. 18. This bill would allow the affiliation of commercial banking and investment banking under a bank holding company that is regulated by the Federal Reserve Board. The bill would also amend the Bank Holding Company Act to allow some breach of the banking and commerce wall. It would do this by allowing the Federal Reserve Board to allow bank holding companies to own companies that are financial in nature, except for insurance underwriters. This would amend the current provision that requires bank holding company subsidiaries to be closely related to the business of banking, as determined by the Federal Reserve Board.

The bill contains firewalls substantially in excess of those in Congressman Baker's bill. However, in our view, the questions are still open about: whether the protections in the bill are sufficient to protect (1) the safety and soundness of the banking system; (2) the legitimate competitive interests of all banks, and not just the large banks that can take advantage of what the bill offers; and (3) the potential conflicts of interest that arise because of the affiliation of such diverse entities. Clearly the Leach bill will further concentrate our financial services industry at the very same time that the banking industry is restructuring and consolidating in response to the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

The IBAA is currently studying these issues to determine the most probable manner that banking and Main Street America will be affected by H.R. 18. We recognize that the financial services industry has changed significantly over the last two decades, both nationally and internationally. We also recognize that large banking companies compete in different markets than community banks, and therefore may need to exercise powers that they do not now possess in order to compete in those markets. However, granting large banks powers cannot be at the expense of community banks and the communities and small businesses that they serve so well.

These issues need to be fully examined in the debate over reform of Glass-Steagall. Although H.R. 18 certainly goes down the road to protecting these important interests, more evidence is necessary to determine if it in fact gets there.

NON-BANK BANK GROWTH CAP

In 1987, the Competitive Equality Banking Act (CEBA) closed the non-bank bank loophole to the Bank Holding Company Act. The loophole exempted banks that did not make commercial loans from the requirements of the Bank Holding Company Act, thus allowing the mixing of banking and commerce. CEBA also imposed restrictions on the grandfathered companies that owned non-bank banks, including limiting the asset growth of the non-bank bank to no greater than 7% during any 12-month period. H.R. 18 would eliminate the 7% growth cap.

The non-bank bank loophole eroded the separation of banking and commerce, created competitive inequalities in the financial system, undermined the ability of the bank regulators to maintain a safe and sound banking system, and jeopardized the payments system. These things occurred because the non-bank bank loophole breached the wall between banking and commerce. As noted above, both former FDIC Chairman Seidman and former Fed Chairman Volcker testified before the Senate Banking Committee in support of closing the non-bank bank loophole.

Maintaining the wall between banking and commerce is critical to the free-enterprise system. Our system relies on banks to allocate credit to its most productive uses. Separating banking and commerce insures that credit is allocated impartially and without conflicts of interest. Breaching that wall raises the risk that credit decisions will be based on the business strategies of the bank's corporate parent and not on economic merit.

As noted above, non-bank banks and their affiliates enjoyed an unfair advantage over bank holding companies and over commercial firms not associated with a non-bank bank because of cross selling of services.

It is also clear that non-bank banks undermine bank supervision by threatening the safety and soundness of our financial system, because there is no practical way to separate a non-bank bank from its affiliates, either operationally or in the public's perception.

Finally non-bank banks jeopardize the payments system. This is because large diversified companies gain access to the system. The main safeguards in the system against the rippling effects of a default are the creditworthiness of the bank making the transfer and its willingness to make an independent credit judgement about its customers. A non-bank bank cannot, as a practical matter make such an independent judgement about an affiliate and resist that company's orders to make payments that would create overdrafts.

UNITARY THRIFT HOLDING COMPANIES

The unitary thrift holding company loophole also breaches the separation of banking and commerce. Under current law, unitary thrift holding companies are not prohibited from affiliating with commercial firms. This has allowed thrifts to affiliate with industrial and other types of companies in violation of prudent safety and soundness principles. We believe the potential systemic risks permitted by this loophole should be a concern to lawmakers. The risks of merging banking and commerce are just as applicable to the thrift industry as they are to the banking industry. Repealing the exemption would level the playing field and put all insured financial institutions in parity.

CONCLUSION

The Glass-Steagall Act and the Bank Holding Company Act have provided significant protections to our banking system and preserved competitive equality in this country. This has given the United States an economic and financial system which is the envy of the world. Efforts to make major changes in the system should be undertaken only after great deliberation. Additionally, changes should be made on an incremental basis. No one can predict with certainty what the outcome of the proposed changes will be. If we take too great a leap, we could find that we have fallen down the precipice. Change can destroy as well as build. We are still witnesses to the ongoing destruction of the savings and loan industry -- a process that was hastened by public policy decisions.

I wish to thank Chairman Leach and this Committee for the opportunity tc present the views of the IBAA on this important topic.

TESTIMONY

OF

ROBERT M. FREEMAN
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
SIGNET BANKING CORPORATION

ON BEHALF OF
THE BANKERS ROUNDTABLE

BEFORE THE
HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING AND FINANCIAL SERVICES

MARCH 7, 1995

Introduction

Mr. Chairman and members of the committee, I am Robert M. Freeman, Chairman and Chief Executive Officer of Signet Banking Corporation in Richmond, Virginia, a $10 billion diversified banking firm. I am pleased to appear today on behalf of The Bankers Roundtable to address the important issue of modernizing United States banking law. I have been privileged to serve this year as President of the Roundtable, the membership of which is open to the nation's 125 largest banking companies. They range in size from over $200 billion to $2 billion in assets, representing some 70% of the commercial banking assets in the U.S.

The Roundtable appreciates your efforts Mr. Chairman to focus on legislation that would modernize the nation's banking laws by the early introduction of the Financial Services Competitiveness Act of 1995 (H.R. 18 and H.R. 1062). We appreciate your long standing commitment and that of the Committee to making needed reforms. We support the effort you are undertaking.

General Comments

Mr. Chairman and members of the Committee, the Roundtable's view of financial services reform is summarized in our Products and Services Policy Statement attached to my statement. In our view, significant changes are needed to keep our financial services system healthy, stable and capable of meeting user needs well into the future. The Roundtable has provided the Committee with its broad recommendations for achieving this objective. We will be pleased to work with you in attaining them.

Role of Banking. The Bankers Roundtable believes that the public will be best served by laws that allow the banking system to meet the needs of consumers, businesses and governments efficiently, conveniently and economically. Banks play a fundamental role in our nation's economy. They are crucial to the conduct of monetary policy and play a central role in the payments system. Because of this, it is important that the business of banking be conducted safely and soundly.

It is the responsibility of bank management to see that appropriate credit and investment policies and practices are in place for managing and controlling the risks that are inherent in the business of banking. Bank boards of directors also must be involved in this process.

It is vital that the banking franchise be maintained and strengthened not only for the benefit of the institution, but also for the benefit of users and the health of the overall economy. U.S. banking policy makers and bankers must meet the challenge of assuring that the banking system remains responsive to user needs consistent with safety and soundness objectives.

Criteria for Reform. As we work to make our banking and financial system stronger, The Bankers Roundtable believes that a number of principles are key to legislation.

(1) Foremost is maintaining safety and soundness.
(2) The need to improve the delivery of financial products and services to users.
(3) The enhancement of competition in the financial services marketplace.
(4) The creation of a clear legal framework on which providers and users of financial products and services may rely.
(5) The need for flexibility in management decisionmaking.
(6) The encouragement of product innovation and of flexible corporate structures to provide financial products and services that meet consumer needs.
(7) The development of an incentive-based regulatory system, that supports prudent operations by institutions and permits the best-equipped firms to meet user needs.
(8) The continuing integration into the banking system of technological developments that improve the ability to create and deliver financial, payment and related information services to customers.

The Bankers Roundtable believes that reforms can be made to U.S. banking law that meet these criteria; we are also cognizant that their achievement may take time and require incremental, but positive, solutions.

Consistent with our recommendations, The Bankers Roundtable supports H.R. 1062 as a strong statement of needed reform. The Roundtable supports the effort you are undertaking and is committed to work with you in developing the concept to its fullest.

The Bankers Roundtable has an important caveat that must be emphasized here. We cannot support any legislation that takes away from the products and services authority that banks now have. Banks should not be asked to retreat from the position they occupy today. Indeed, there are banks that may wish to retain the concept of a "pure" commercial bank or even return to that approach over time. Federal policy should enhance the fundamental bank franchise, such as by authorizing revenue bond underwriting as envisioned in H.R. 1062. The Roundtable cannot support legislation that would undermine the activities in which banks engage today or legislation that prevents banking from meeting user needs in the financial marketplace of the future. Extraneous amendments limiting banking products and services must be rejected.

Important Role of Technology. One of the most important influences on the ability to deliver financial products and services today is new technological development. New technology has permitted traditional lines of banking businesses, such as mortgage lending, to be accomplished more rapidly and conveniently. Technology has permitted new lines of business, such as credit, debit and "smart" cards, to provide significant benefits to consumers and governments. Technology is changing the way in which most, if not all, banking and financial products and services will be delivered to consumers, business and government in the future.

Banks are seeking to enhance their capabilities for delivering financial, payment and related information services to users in new and innovative ways. For example, we just established at Signet Bank a computer-based system to provide college students with information about loans and grants that can be accessed through the Internet system. Other banks throughout the country are establishing financial and information services of their own that rely on similar technologies.

Nonbanking companies, including telecommunication, data processing and software firms, also are seeking to establish or expand their networks for delivering financial, payments and related information services. Companies such as AT&T, for example, offer credit cards to their customers; software firms such as Intuit are marketing financial programs to users. Plans by these and other nonbanking firms for delivering banking and financial products and services to users are under active consideration and development.

The implications of such developments for U.S. banking policy are enormous. Nonbanking firms, many of which are not as highly regulated as banks, are capable of offering diverse financial and nonfinancial products and services to the public. Many changes in the delivery of banking and financial services can be expected to come from revisions in telecommunications laws and regulations adopted by the Federal Communications Commission just as certainly as they come from actions of the Federal Reserve Board or the Office of the Comptroller of the Currency.

Technological change also means that the definitions of financial providers will become increasingly outdated as more and more services are delivered by means of computer-based and other technology-based information systems. It is already envisioned that individuals will be able to conduct their banking and financial business from the comfort of an easy chair in their living rooms by merely clicking their remote control to a cable channel of their television that allows them to access their checking, savings, investment and credit accounts at banks, other financial institutions or nonbanking firms any time they wish. In the future, we

may be just as likely to meet our customers across an electronic network as in a bank lobby or across a board room table.

The legislation before the Committee at this time suggests that Congress recognizes that changes in U.S. banking and financial law need to be made. The gap between banking and other financial businesses needs to be bridged, which the legislation certainly would help achieve. While Congress may not be willing to bridge the gap now between banking and commerce, it needs to recognize that technological developments are making it increasingly possible for nonbanking firms to offer the types of financial, payments and related information services that banks have traditionally provided to users; innovation in the marketplace will continue and accelerate.

We urge special attention be paid to the impact that proposed legislation deregulating the nation's telecommunications systems would have on the ability of banks to remain competitive. Changes in these systems hold enormous potential for delivering financial, payments and related information services outside the banking system utilizing existing and emerging technologies. Congress should assure that banks may continue to take advantage of new technologies in offering financial, payment and information related services directly to customers or are allowed to do so by affiliating with firms that are engaged in those lines of business.

III. Comments on H.R. 1062

As noted earlier, H.R. 1062 is a significant step forward in modernizing the banking and financial system. The Roundtable looks forward to working with committee members in developing the legislation.

The membership of The Bankers Roundtable is in a good position to help in this matter. They are experienced in the business of underwriting and dealing in government securities directly in their banks and in underwriting equity and debt securities and engaging in dealer activities through Section 20 operations of their holding companies. This involvement, in the bank and in the holding company, has proven beneficial to consumers, businesses and governments.

Revenue Bonds. The legislation provides a step forward by adding revenue bond underwriting to bank product lines, though with a limitation based on geography. Banks have traditionally underwritten general obligation securities of state and local governments, and the ability to underwrite revenue bonds is desirable and fits with long-standing banking services for governments. The

Roundtable believes that the existing banking franchise must be enhanced through expanded product lines and reduced regulatory burden.

Two Way Street. The Roundtable supports a "two-way street" for banking and securities firms. Such a system should be attained without undue restraints and uneconomic conditions, while still maintaining the safety and soundness of the institutions involved. Any bank with access to the payments system and discount window must meet the high standards that have been established. The Roundtable recognizes that it is difficult today to find firms that are unaffiliated with some form of enterprise outside the business of banking or securities underwriting and recognizes that divestiture of product lines may pose problems. We look forward to working on this issue with you.

Structures for Affiliation. The Bankers Roundtable urges that various structures for affiliation be available. The Roundtable considers holding companies to be a useful model. We also believe that bank operating subsidiaries, properly structured, may offer safe vehicles for providing services. What is important is that corporate managers, based on capital and management strength, should be able to adopt structures that meet user needs and demands. Regulators currently have ample authority to manage these structures.

Regulation, New Products & Streamlined Procedures. Regulation should turn more to supervision and away from micro management. The Congress took positive steps in that direction in the Riegle Community Development and Regulatory Improvement Act of 1994, which reduced regulatory burden. Institutions with strong capital positions and able managements should see less regulation and greater freedom to innovate products and methods for their delivery. The Roundtable supports such a system of incentive-based regulation, which H.R. 1062 envisions by focusing on strongly capitalized banks and by the permitting the Federal Reserve to modify safeguards provided in the bill; this is an approach that should be expanded.

H.R. 1062 contains other commendable provisions, long advocated by the Roundtable, which move toward an improved regulatory structure. First, the bill would revise Section 4(c)(8) of the Bank Holding Company Act-- which governs Federal Reserve Board consideration of new "nonbanking" financial activities. H.R. 1062 would replace the traditional "closely related" to banking test with a new "financial in nature" rule that would permit more flexible action by the Board to approve products and services as the financial marketplace evolves. Second, the legislation would modify the current application process for nonbanking activities. By providing a notice procedure for most activities and streamlining the process to

permit expedited action, H.R. 1062 goes a long way toward placing banking organizations on a more equal footing with nonbanking providers of such services. The benefits of these two changes cannot be overstated.

Cross Marketing. A key benefit of affiliation should be consumer benefits. This depends on the ability to cross market and package products and services. The value to users is to find products packaged the way they desire and available when and where they desire, while institutions maintain their safety and soundness, and without anticompetitive practices. The current overlay of antitrust and banking laws-- tying and disclosure rules-- provide consumer protections, while still permitting packaging of products to suit user needs. H.R. 1062 does not limit cross marketing and looks to consumer disclosures as a key element in avoiding problems. Indeed, the bill will support cross marketing and diminish the capability of any one firm to engage in anti-competitive tying practices by increasing competition and providing users with a wider array of choices.

Safeguards. The Roundtable believes that the Committee should modernize the law with the knowledge that a full panoply of safeguards are already in place. These safeguards protect the deposit insurance system and the consumer; any new proposed restraints must meet the test of adding to safety and soundness, not duplicating current rules nor dampening competition. I have attached a memorandum to my statement that highlights the many safety and soundness protections for banks, taxpayers and the deposit insurance system that are already in place. It shows a rather extensive and comprehensive list of safeguards.

The Roundtable will be continuing its analysis of H.R. 1062 and would appreciate the opportunity to communicate to the Committee regarding any safeguards that may be unnecessary in light of existing federal law and regulation.

IV. Conclusion

The Bankers Roundtable supports the efforts underway in this committee to modernize U.S. banking law. You have initiated a process that ultimately will benefit the entire financial services system and, most importantly, the users of products and services. We look forward to assisting the Committee in developing a solid plan for action that works in practice, is beneficial to the public and is achievable.

Again, thank you for the opportunity to testify, Mr. Chairman.

Attachment 1

The Bankers Roundtable
Policy Statement on Products and Services Legislation

The Bankers Roundtable supports congressional action reforming the law of financial institutions to provide users of products and services greater choice at a lower cost while maintaining fundamental safety and soundness.

The Roundtable believes that current regulatory authorities, which have been greatly enhanced over the past six years, provide more than enough safeguards to permit expansion of banking products and services and affiliation of banks with nonbanking firms. Additionally, new laws and regulatory tools have provided thorough insulation for the deposit insurance funds. Flexibility of corporate structures and a more supervisory approach to regulation, rather than micro management, will benefit wholesale and retail customers.

The Roundtable cannot support initiatives that would reduce or constrict the offering of products and services or create new "safeguards" that are, in reality, anti-competitive, add nothing to safety and soundness and make the offering of expanded product lines uneconomic.

Approved by Board of Directors
The Bankers Roundtable
March 1, 1995

Attachment 2

Safeguards in Banking Law and Regulation--
Protection of Banks, Depositors and Taxpayers

Introduction

Federal law and regulation governing the business of banking focuses on ensuring that our private sector banking industry operates in a fashion that at once extends credit based on risk evaluations and undertakes to do so in the safest manner possible. This view of regulation is tied to banking's important role in managing customer monies and in affecting the flow and cost of credit.

As users of financial services have demanded new and different products, packaged and offered in new delivery systems, the law has denied the financial system and users of products a cost effective marketplace that insures ongoing stability and safety. Arbitrary product rules and corporate structures inhibit user access and, despite meritorious goals, actually interfere with the maintenance of safety and soundness by limiting institutional growth and diversity.

Lawmakers may expand bank product and services-- directly and through affiliation with nonbanking firms-- and, at the same time, be assured of continued protection of the public, the taxpayers and the marketplace.

While the marketplace provides many safeguards, Congress has erected a legal and regulatory structure (some of which may not have continued validity) that insulates banks and the taxpayer and contains strong regulatory tools to prevent abuse. The laws and regulations summarized here support the reality that modernization of the law can be undertaken in confidence against a backdrop of a comprehensive legal regime.

Clearly what is needed is affirmative legislation, spurring new products for users offered in a safe and sound manner. This may be accomplished by looking beyond the current foundation to a system of incentive-based regulation for well managed, strongly capitalized and efficient institutions.

What follows is a brief summation of a number of the safeguards that exist to deter and punish undesired behavior.

The Bankers Roundtable
March 1995

I. Prevention and Oversight Mechanisms

A number of statutory and regulatory tools exist to prevent and avoid threats to banks or the deposit insurance system.

A. Examinations

1. **Self review.** Regulators require institutions to review their business operations and submit "Call Reports" or reports of condition. These reports cover over 900 individual business lines and business practices.

2. **Regulatory examinations.** Generally, each bank must be examined annually. Larger institutions have full time examiners resident in the bank or holding company.

B. Application and Approval Requirements

1. **Regulatory Oversight.** The Office of the Comptroller of the Currency requires prior notice and opportunity to disapprove activities to be conducted in national bank subsidiaries. Furthermore, the OCC examines the subsidiary and may take enforcement action or order the termination of any activity that endangers the safety and soundness of the bank. The Bank Holding Company Act requires the Federal Reserve Board to review and approve each application to perform a nonbanking activity; 12 USC 1843(c)(8).

2. **Institutional Changes.** The Change in Bank Control Act requires specific filings and findings regarding individuals or companies involved in acquiring or overseeing a banking institution. The Bank Merger Act, along with the antitrust laws, provide further limits on the acquisition of a banking institution. The FDIC may disapprove new board members and senior officers in certain situations; 12 USC 1831i.

C. Capital and Bank Strength

1. **Restrictions on Payment of Dividends.** If regulators determine that some problem exists for a national bank and that the bank may be unable to manage the problem without stronger finances, regulators may restrict the declaration and payment of dividends by a national bank. Banks may not pay dividends out of capital; 12 USC 56. A bank must receive regulatory approval before paying, in any calendar year, dividends exceeding the total of the year's net profits combined with the retained net profits of the preceding two years (less any required transfers to surplus); 12 USC 60. Next, regulators wield the power to issue "capital directives" that direct a bank to what degree or whether it may issue dividends at a time when capital needs to be increased.

2. **Capital Plans.** If a bank's capital drops below a certain level, regulators may act to require a bank or its holding company to develop a plan of action to restore capital to higher levels. During this time, bank activities are strictly controlled or curtailed.

3. Risk Based Capital. Since 1983, regulators have developed a regulatory scheme that requires capital to be maintained, that limits new bank activities or acquisitions unless capital is maintained and exceeded and that ties the level of capital to the type of business in which the bank engages; 12 USC 3907. This encourages safer investments and reinforces the idea that only strong, well managed institutions that can raise higher capital may engage in new business ventures or acquisitions.

D. Lending Limitations

1. Individual Borrowers. To prevent concentration of lending as well as abuse of lending, banks are limited in their lending to a single borrower, using an aggregation method that prevents avoidance. For example, the National Bank Act limits extensions of credit by a national bank to any single borrower to 15 percent of capital and surplus, 12 USC 84; loans secured by readily marketable collateral are permitted up to an additional 10 percent.

2. Officers, Directors, and Shareholders. To prevent internal lending abuse, additional rules govern loans to "insiders." For example, Sections 22(g) and (h) of the Federal Reserve Act restrict credit to executive officers, directors and principal shareholders in a bank, a holding company or affiliates; 12 USC 375a & 375b. Also, credit must be extended on a nonpreferential, "arm's length" basis, and may not involve more than the normal form of repayment or exceed the individual lending limit under which banks operate; 12 USC 84. Loans are allowed only up to a limit prescribed by the regulator with prior approval required for loans of a certain amount. Section 106(b) of the Bank Holding Company Amendments Act of 1970 establishes similar requirements for extensions of credit made to officers, directors and principal shareholders of correspondent banks; 12 USC 1972.

II. Lending Practices Restrictions

A major concern of policy makers is that lenders deal fairly with the public and not control a market and require borrowers to purchase products they do not desire. This is addressed both under the antitrust laws and specific bank law.

A. Retail Banking Laws

Over 25 separate laws govern the provision of retail banking products, governing general business practices, such as disclosures, to specific laws for specific products, such as the law governing home equity loans. Almost all contain enforcement regimes, with significant penalties for violations and many permit private rights of action. Regulators have enforced these laws vigorously.

B. Anti-Tying Restrictions

Banks may not condition sale of a banking product on the purchase of another product. Section 106 of the Bank Holding Company Amendments Act of 1970 generally prohibits a federally insured bank from providing services or extending credit on the condition that a customer obtain an additional service of the parent holding company or an affiliate (or refrain from obtaining services of a bank competitor); 12 USC 1972. Banks may package or bundle products for sale, but may not require purchase of products. The Act provides injunctive relief and treble damages as remedies for the injured customer.

III. Enforcement Authorities

Regulators possess a wide array of enforcement tools that range all the way from informal negotiations with banks to moving to seize a bank or remove its ability to offer deposit insurance. Following are several key regulatory enforcement tools:

A. Cease and Desist Authority

The federal bank regulators have cease and desist authority to address violations of law and unsafe and unsound practices, and violations of any law or regulation by banks under their supervision; 12 USC 1818. This authority allows agency proceedings requiring any bank or bank holding company (or its directors, officers, employees, or agents) to cease and desist from unsafe and unsound practices or violations of law, and to take whatever affirmative action is necessary to correct the conditions resulting from the violations or practices.

In addition, the Board may require the termination of any holding company activity or a holding company's ownership of any nonbanking subsidiary that is judged to threaten the safety, soundness, or stability of the holding company's banks; 12 USC 1844(e). The OCC has similar authority to terminate activities of bank operating subsidiaries.

B. Civil Money Penalty Authority

Various federal statutes give federal bank regulatory agencies authority to assess civil money penalties against any bank, officer, employee or agent responsible for a violation; 12 USC 93, 504, 1818, 1828, 1847 & 1972. In addition, the Federal Reserve has civil money penalty authority for violations of the Bank Holding Company Act; 12 USC 1847. Violations of Federal Reserve Act Sections 23A & 23B and other statutes which restrict transactions between a bank and its affiliates are generally punishable by civil money penalties for each day during which the violation continues.

C. Removal Authority

Federal bank regulators also have authority to suspend or remove any director or officer of an insured bank who has engaged in unsafe and unsound banking practices, a breach of fiduciary duty or a violations of law which results in loss to the bank, prejudice to depositor interests or insider gain, and which involve personal dishonesty or, a willful disregard for the bank; 12 USC 1818(e). As a result of such a removal, the directors and officers also may be prohibited from participating in the affairs of any other insured bank without the approval of the appropriate federal regulator; 12 USC 1818(j).

D. Deposit Insurance

Deposit insurance is critical to the business of depository institutions. The FDIC may deny an application for insurance and has the ability to terminate insurance at an institution; 12 USC 1818.

IV. Dealings with Affiliates

Bank regulators have authority to oversee bank and affiliate relationships. The authorities include oversight, enforcement and transaction limits; all contain penalties for violations.

A. Examinations

The National Bank Act authorizes the OCC to examine a national bank and the affairs of its affiliates as necessary to disclose fully the relationship and the effect of the relationship upon the bank; 12 USC 481. Pursuant to the Bank Holding Company Act, the Federal Reserve Board is authorized to conduct examinations of the holding company and all subsidiaries of a holding company, including the nonbanking subsidiaries; 12 USC 1844. In addition, under the Federal Reserve Act, the Board may examine all affiliates of a state member bank; 12 USC 338. Similar authority is granted to the FDIC with respect to affiliates of insured banks; 12 USC 1820(b). Finally, the FDIC has stand by, "back up" enforcement authority if it has reason to believe problems exist in a bank, even if another regulator has examined an institution.

B. Investigatory Powers

The federal bank regulators have investigatory powers that extend to a bank, officers, directors or employees or agents of a bank, or its affiliates. The regulators may issue a formal order of investigation which extends to entities or persons which are not national banks or employees of national banks.

C. Reporting Requirements

National banks must file with the office of the Comptroller of the Currency four times a year, reports that disclose fully the relations between a bank and its affiliates; 12 USC 161. These reports must be verified by the oath of each affiliate's president or other designated officer. States member banks must file identical reports with the Federal Reserve Board three times a year; 12 USC 334. Any national or state member bank that fails to furnish the required reports is subject to a penalty for each day the violation continues.

D. Regulation of Financial Transactions

Section 23A of the Federal Reseve Act restricts certain transactions between banks and their affiliates; the rule has been applied by the FDIC to banks it regulates; 12 USC 371c & 1828(j). For example, collateral requirements are set at 100 to 130% on certain credit transactions. Also, an overall cap-- a percentage of bank capital-- exists on covered transactions with affiliates. Section 23B requires covered bank transactions with affiliates to be on an "arm's length" basis, avoiding disadvantaging of unaffiliated firms; 12 USC 371c-1. Section 23B relates to securities affiliates as the section was proposed as part of a bill granting banks new securities powers; the safeguard became law, the new securities authorities did not.

V. Crimes and Penalties

The following is a list of major statutes that criminalize behavior that relates to banks and a brief description of recently-expanded regulatory authorities.

A. Federal Laws Creating Criminal Liability for Banking Activities

Among major statutes relating to criminal activities involving depository institutions are the following:

Bank Bribery Act, 12 USC 2213.
Bank Fraud Act, 18 USC 1344.
Bank Protection Act, 12 USC 1881.
Bank Robbery Act, 18 USC 2213.
Bank Secrecy Act, PL 91-508.
Change in Bank Control Act, 12 USC 1817(j).
Crime Control Act of 1990, PL 101-647.
Federal Deposit Insurance Corporation Improvement Act, PL 102-242.
Financial Institutions Reform, Recovery and Enforcement Act, PL 101-73.
Right to Financial Privacy Act, PL 95-630.

B. Selected Crimes and Regulatory Authorities

Recent laws have expanded liability for crimes and increased civil and criminal penalties. All of these go toward deterring undesired behavior.

1. Liability for criminal and civil violations goes beyond banks to "institution-affiliated" parties, such as lawyers, accountants, etc.

2. Penalties for violations of banking laws can run to $1 million a day for harm to an institution and for failing to make required regulatory reports.

3. Impeding the work of banking agencies, including examinations, contains a criminal penalty of up to five years in jail.

4. Convictions for criminal offenses involving dishonesty prevent service as an officer, director or employee of an insured institution, including being banned for life.

5. Forfeiture of property is provided in cases of law violations.

6. Wiretap authority exists for bank fraud cases.

7. The Justice Department has a financial institutions fraud unit.

8. Enforcement actions against banks and their affiliates are disclosed to the public.

VI. Protections Insulating the Deposit Insurance System

With crises facing savings institutions in the mid 1980s and a decline in the reserves of the insurance funds, protections for the deposit insurance funds and, ultimately, the taxpayer were enhanced. Today, thorough insulation of the deposit insurance funds and their mandated financial strength provide assurance that individual bank failures will not threaten the funds with significant losses.

Apart from the many regulatory tools, criminal and civil sanctions and preventive measures cited above, other laws and rules add to protection of the deposit insurance funds.

A. Premiums and Capital

1. **Risk Based Premium System.** In 1991, the FDIC moved to a risk based premium system that mirrors to a degree the risk based capital system. Insurance premiums are assessed on the level of risk presented to the insurance funds. Institutions with higher risk pay higher premiums; lower risk, well capitalized firms pay less.

2. **Risk Based Capital System.** Since 1983, bank regulators have developed a risk based capital system. By requiring more capital for those financial institution assets that are perceived to pose greater risks, regulators insulate the institution and the funds from losses. Risk based premiums and capital prevent losses by steering institutions to lower risk credits as well as insulate the deposit insurance funds by insuring that capital exists and premiums are paid against losses.

B. Protection from Losses

1. **Fund Reserve Ratios.** Insurance funds are required to maintain a minimum ratio of reserves to protect against losses. (The current 1.25% reserve ratio is considered too high by many commentators, in light of actual loss experiences and additional safeguards described below.)

2. **Early Intervention; Prompt Corrective Action.** Instead of waiting to deal with institutional failures when all assets are depleted, regulators must act early to intervene while capital remains and an institution may be salvaged. This may avoid a failure and, if an institution fails, minimize its cost. The intervention schedule calls for increasing regulatory action tied to declining capital; 12 USC 1831o(e).

If damage to the institution appears to be dire, despite regulatory efforts, regulators are directed to move promptly to limit further transactions, force divestiture of businesses and even to dismiss officers and directors and sell the bank; 12 USC 1831o(f)-(I).

Critically undercapitalized institutions are subject to swift action to limit their issuance of debt, to take them over through receivership or conservatorship and to limit their business activities until they can be recapitalized or sold; 12 USC 1831o(h).

3. **Least Cost Resolution.** The law favors quick and decisive action with troubled banks, avoiding practices by the FDIC that could increase the cost to the funds if an institution should ultimately fail. The FDIC is directed to employ specified decisionmaking tools. Generally, once certain benchmarks are reached, an institution must be closed except in situations where a threat to the system would be created by a failure. Even sales of an institution must occur with the least involvement by the FDIC. Generally, 12 USC 1823(c).

4. **Cross Guarantees.** If an institution that is commonly controlled with other depositories fails, then the affiliated banks must contribute to the FDIC the amount of its loss or anticipated loss. 12 USC 1815(e).

5. **Capital Plans.** As bank capital declines, regulators are authorized to require owners to come up with capital plans to restore capital strength to an institution; 12 USC 1831o(e)(2). Capital plans are subject to guarantees by holding companies; 12 USC 1831o(e)(2)(C)(ii).

6. **Growth Limitations.** If a bank is in an undercapitalized position, regulators may limits its asset growth and limit any acquisitions or entering of new lines of business; 12 USC 1831o(e)(3)&(4).

7. **Depositor Preference.** As part of the Omnibus Budget Reconciliation Act of 1993, a new system for handling failed bank assets was created that greatly enhanced the protection of the insurance funds. The law increases the return to the government over general creditors with the distribution of assets placing the FDIC's claims in a clearly senior position. 12 USC 1821(d)(11). The likelihood of FDIC losses in a failing bank situation are very small, especially when coupled with FDIC action under the early intervention rules when capital still remains in the institution.

8. **Change in Bank Control Act.** This law, which requires prospective owners of banks to file background materials, was enhanced in 1991 and will assist in avoiding unscrupulous parties entering the banking business.

9. **Limit on Risky State Bank Activities.** In 1991, insured state bank activities, in a principal capacity, were limited to those permissible to insured federal banks. The FDIC may permit some broader activities if a finding is made that the activity creates no threat to the insurance fund and the institution had strong capital.

VII. General Rulemaking Authority

Federal banking agencies have general rulemaking authority that may be used to promulgate new regulations or amend existing regulations as needed to provide appropriate safeguards for banks and their customers; for example, 12 USC 93a.

Testimony of

Weller Meyer
President & CEO
Acacia Federal Savings Bank
Falls Church, Virginia

before the
Committee on Banking and Financial Services

Hearing on
H.R. 1062, the "Financial Services Competitiveness Act of 1995"

Tuesday, March 7, 1995, 10:00 a.m.
2128 Rayburn House Office Building

◆ ◆ ◆

America's Community Bankers
900 19th Street, N.W., Suite 400
Washington, DC 20006
(202) 857-3100

Mr. Chairman, my name is Weller Meyer. I am President and CEO of Acacia Federal Savings Bank which is located in Falls Church, Virginia.

Acacia Federal, a member of The Acacia Group, was chartered in 1985, and is about to celebrate its 10th anniversary Acacia Federal ranks in the top quartile of thrifts in the Nation with assets of $400 million. Acacia Federal employs 48 persons Acacia Federal s parent company, Acacia Mutual Life, was chartered by a Special Act of Congress in 1869. Throughout the 125 years of its existence, Acacia Mutual has enjoyed a well-earned reputation for financial strength and stability, prudent investment practices and leadership in the insurance industry.

Today I am representing America's Community Bankers, the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets 270 000 employees and 16,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance and community development.

In general, ACB strongly supports financial modernization efforts, such as last year's interstate banking and branching legislation and current efforts to reform the Glass-Steagall Act. We believe that each firm should be able to decide for itself -- within the bounds of safety and soundness the business strategy and corporate structure that will best allow it to compete in today's dynamic economy That is why we vigorously oppose the attempts in H.R. 18 and H.R. 1062 to repeal or sharply circumscribe the long-standing unitary holding company option now available to savings institutions. These proposals are dramatically opposed to the overall thrust of the bill, which is to increase, not limit, new competitive opportunities. We urge that this Committee completely remove the limitation on unitary holding companies included in H.R. 1062.

Summary

ACB opposed H.R. 18's proposed repeal of the unitary holding company option for many reasons. A wide variety of institutions joined our "Defend Unitary Activities Coalition" to help with the effort.

- We determined that the bill would seriously disrupt existing consumer and business relationships and cause serious economic losses.

- There is no public policy justification for eliminating the unitary option because existing law fully protects consumers and the FDIC.

- The looming BIF/SAIF premium disparity means that SAIF-insured institutions may soon be paying much higher deposit insurance premiums than other institutions. At this critical time the bill would deny savings institutions access to an important source of new capital and earnings.

The revised legislation, H.R. 1062, proposes to grandfather those unitary holding companies that had organized by January 4, 1995. This is an unacceptable alternative to maintaining existing law.

- Two-thirds of the industry had not formed unitary holding companies by that date and would lose an important business option and part of their franchise value.

- Even those that are grandfathered would be hurt, because savings institutions would lose their grandfathered status if they were sold to another firm.

- The unitary prohibition goes against thrust of the bill and implies that there is something wrong with the activities we are pursuing. Nothing could be further from the facts.

Defend Unitary Activities Coalition

Acacia is just one example of the firms that utilize the unitary holding company form, or that plan to do so in the future. America's Community Bankers organized a nationwide coalition to defend unitary activities. The coalition has twice written to each Member of Congress urging them to maintain the unitary option. These letters, along with a list of coalition members, are attached to this testimony.

The Coalition is diverse, including institutions of all sizes from communities throughout the country. State savings institution and benkers associations have joined. Major institutions are represented, along with smaller companies located in states such as Iowa, New Jersey, Minnesota, and Pennsylvania. Very concerned members are located in Hattiesburg, Mississippi and Travelers Rest, South Carolina.

Advantages of Unitary Powers

Banking and Commerce

Savings institutions have affiliated with non-financial firms for decades. While Congress has enacted legislation maintaining the separation of banking and commerce on several occasions it has not sought to limit the combination of savings institutions and diverse firms. The limited commercial lending powers of savings institutions provides ample justification for this approach. Last week s testimony by Acting OTS Director Jonathan Fiechter before this Committee provided an excellent account of the legislative history of this issue and the reasons that the unitary holding company provisions should remain in place.

Savings institutions have very circumscribed commercial lending authority and they may only affiliate with non-financial companies if they meet a strict "qualified thrift lender (QTL) test." That test requires them to specialize in the delivery of housing credit. This housing commitment and the limit on commercial lending remove the concern that a savings institution controlled by diversified holding company would be able to distort the flows of commercial credit by discriminating against the competitors of its affiliates.

The concern over affiliation with commercial firms is overstated even with respect to commercial banks, given the massive replacement of bank lending by commercial paper and corporate debt issuances. We know this Committee will be looking at this issue in depth as it debates H.R. 1062 and Representative Baker's legislation that would permit banks to affiliate with commercial firms. We submit that the unitary savings and loan holding company form could provide a model for the future; it should not be circumscribed by a prohibition and limited grandfather clause.

Effect on Consumers

An outright prohibition on unitary activities, such as proposed in H.R. 18, would harm consumers. It would deny them convenient and competitive services that unitary companies now provide. Many unitary holding companies offer one-stop shopping that is particularly valuable to increasingly busy customers. The grandfather provision in H.R. 1062 would deny these benefits to additional consumers throughout the country. Existing unitary holding companies would also be reluctant to invest more resources into their savings institution subsidiaries because the savings institution could not be sold to another diversified firm. Thus, even grandfathered institutions would be less likely to grow and provide new services to consumers.

Acacia Federal offers its clients a wide variety of banking products and services Savings vehicles include custom-designed certificates of deposit with maturity options from 90 days to 5 years; flexible money market checking - with check writing privileges and money market rates; and no-fee IRAs. All Acacia Federal deposits are FDIC-insured up to $100,000 Acacia Federal also offers residential mortgage loans, including fixed and adjustable rate first trust mortgages second trust loans and home equity lines of credit. It also offers automobile loans, unsecured credit lines, and secured and unsecured personal loans.

These services are easily available to customers of Acacia Federal's affiliates. By the same token Acacia Federal customers can also obtain services from the holding company

While often providing the advantages of one-stop shopping, unitary holding companies and their savings institutions must adhere to strict anti-tying limitations. In addition, they must follow special procedures to ensure that customers understand the differences between insured deposits and uninsured products.

Safety and Soundness Protection

Acting Director Fiechter's testimony outlined the extensive statutory and regulatory safety and soundness requirements that unitary holding companies and their savings institutions must meet.

- OTS must approve any holding company acquisition;
- holding companies must report regularly to OTS on a wide variety of financial and managerial matters;
- transactions between the holding company and the savings institution are subject to strict statutory restrictions including arm's length pricing;
- savings institutions must maintain adequate capital or they may not pay dividends to their holding companies; and,
- OTS imposes case-specific restrictions where needed.

The OTS conducts examinations of both the holding company and the subsidiary savings institution to enforce these requirements.

Holding Companies Support the Industry

The OTS reports that no systemic problems have resulted from the combination of savings institutions and diversif ed firms In fact, diversified companies have infused billions of capital into savings institutions and continue to do so. Our holding company, the Acacia Group, has provided $15 million in capital to Acacia Federal. Our commitment to Northern Virginia's consumers is strong; we maintain that commitment in a way that would not be possible without holding company resources. For example, Acacia Federa s Trust Department earns revenue by serving as custodian for another affiliate s IRA accounts. Acacia Group advertising benefits Acacia Federal by featuring us in most advertisements and sales materials These, along with joint marketing efforts I described earlier, are but a few examples of how Acacia Federal benefits from our parent company's resources.

As Acting Director Fiechter's testimony pointed out, diversified companies also offer managerial and operational support for savings institutions. In our case, Acacia Federal was formed de novo by our holding company which provided substantial assistance during the start-up phase. Where an existing savings institution is acquired, a holding company can provide additional manageria depth and the expertise to offer new products to consumers Acacia Mutual s Human Resources Department provides human resource support and benefits administration to Acacia Federal, thereby enabling Acacia Federal to avoid salary and related expenses. Acacia Mutual's Tax Department also provides support by preparing and filing federal and state income tax returns, again, enabling us to avoid a considerable expense.

5.

This is the Wrong Time to Damage Savings Institutions

The primary problem that the SAIF segment of our industry faces is the projected 20 basis point disparity between Bank Insurance Fund and Savings Association Insurance Fund premiums and the suffocating competitive disadvantage this will engender. I know that issue is not the subject of today's hearings, and we look forward to presenting detailed testimony later this month. (Attached to this testimony is some additional material on the premium disparity.) However, it is important to point out that limiting the unitary holding company option would put substantial economic pressure on the industry at the same time it is facing a dangerous premium disparity.

Further earnings pressure comes from the government-sponsored secondary market enterprises, Fannie Mae and Freddie Mac. Their ability to raise funds at near-Treasury rates has narrowed the interest margins on conventional, fixed-rate mortgages, a major product of our institutions

Unitary holding companies have been an important private-sector source of strength for our industry that helps us deal with these pressures. We urge you to keep that option in place.

Grandfathering is No Solution

Grandfathering existing unitary holding companies is not an acceptable solution. No one has provided any evidence that the unitary holding company format has led to any problems for savings institutions, their customers, or the government. Sharply limiting the unitary option -- as provided in H.R. 1062 -- flies in the face of the current effort to modernize the financial system. Chairman Greenspan told this Committee last week that he has no philosophical problem with the combination of banking and commerce, but felt that it would be better to gain experience before taking that step. Congress should maintain the unitary option for savings institutions, allowing the regulators to continue to gain relevant experience in this area.

We note that the Committee also has before it legislation introduced by Representative Baker that would permit banks to affiliate with commercial firms. That approach leaves the unitary savings and loan holding company option in place, a result much more in keeping with the general tenor of H.R. 1062. Even the Administration, which recommends maintaining the separation of banking and commerce, recommends leaving the unitary holding company law in place. Treasury Secretary Rubin's testimony last week stated that, "On balance, we believe the unitary thrift holding company exemption represents sound policy and should not be changed, with the one proviso that commercial lending represent no more than 10 percent of such a thrift's assets." (p. 28)

It would be truly ironic if Congress effectively dismantled the unitary holding company option in this legislation, only to come back a few years later and reinstate it. That would lead to the tremendous financial disruption described in our testimony and seriously undermine the credibility of the overall reform effort.

Grandfathering also suggests that there is something improper with the unitary option and those who have used it. Neither the OTS nor any other government agency that has addressed the issue believes that to be the case. And, as our testimony demonstrates, unitary holding companies can considerably strengthen the depository subsidiary. Many companies have relied on the law to pursue legitimate business interests for decades. Congress has had many opportunities to change the law over this period and has not taken them. In short, unitary holding companies have done nothing wrong and should not be punished.

Grandfathering Hurts the Entire Industry

Grandfathering hurts all savings institutions, whether or not they have adopted the unitary holding company format Two-thirds of all savings institutions have not formed unitary holding companies. Maintaining the unitary option is important to their future viability. As the financial services industry evolves, even smaller institutions will have to diversify to remain competitive. The unitary holding company is an important way for savings institutions to maintain and increase their ability to serve their communities. It is important to note that a BIF-insured savings bank may become a subsidiary of a unitary holding company if it adheres to the qualified thrift lender test.

Even grandfathered institutions would be badly damaged by H.R. 1062, since it effectively handcuffs savings institutions to their holding companies. Simply put, the grandfather status lasts only so long as the original owner as of January 4 1995 maintains control Several companies have acquired savings institutions in the past, provided substantial capital and later decided to divest themselves. This is often done in a dynamic economy as companies enter and exit lines of business because of changes in corporate strategy and consumer demand. The grandfather provision in H R 1062 would make this dynamic process much, much harder. A diversified company is completely prohibited from buying a savings association, whether or not it is "grandfathered."

Under the "grandfather" clause, the market for <u>all</u> savings institutions, grandfathered or not, takes a major hit.

7.

Conclusion

America's Community Bankers and the Defand Unitary Activities Coalition strongly urge this Committee to eliminate the provisions in H.R. 1062 that would seriously undermine the ability of savings institutions to affiliate with diversified companies. No one has advanced any compelling public policy arguments for changing long-standing Congressional policy that permits these affiliations. In fact, these affiliations have substantially strengthened our industry. They should be a beacon for the Committee, not turned into a financial pariahs.

DEFEND UNITARY ACTIVITIES COALITION

February 23, 1995

Speaker Newt Gingrich
U.S. House of Representatives
H230 U.S. Capitol Building
Washington, DC 20515

Dear Speaker Gingrich:

Last week, we sent you a letter urging your opposition to a provision in H.R. 18, the Financial Services Competitiveness Act, which would eliminate valuable business opportunities for some 2,000 savings institutions. Since then, a number of institutions have joined the Coalition and asked to have their names added to the letter. Enclosed is a copy of the Coalition letter along with a supplemental list of new members.

The Coalition wishes to reiterate its vigorous opposition to the provision in H.R. 18 which would strike the ability of savings institutions to engage in other lines of business. We have heard proposals to modify the provision, such as imposing new capital or regulatory requirements that would discriminate against our institutions. We have also heard that the bill may retain the prohibition, but grandfather institutions already engaged in broader activities.

The Coalition opposes these kinds of partial measures and urges that the provision be completely eliminated. Discriminatory capital or regulatory requirements are not justified by any public policy considerations. Grandfathering would unfairly disadvantage unitary holding companies that plan to undertake activities in the future, as well as savings institutions that have not yet adopted the holding company format. Any of these modifications would substantially harm the savings institutions at the same time that those insured by the FDIC's Savings Association Insurance Fund will be required to pay far more for Federal Deposit Insurance than Bank Insurance Fund members.

Again, please do what you can to completely eliminate the unitary activities prohibition in H.R. 18.

Defend Unitary Activities Coalition

DEFEND UNITARY ACTIVITIES COALITION

February 16, 1995

Speaker Newt Gingrich
U.S. House of Representatives
H230 U.S. Capitol Building
Washington, DC 20515

Dear Speaker Gingrich:

The Financial Services Competitiveness Act (H.R. 18) would repeal the long-standing ability of a savings institution devoted to housing finance to be part of a holding company that includes non-financial businesses. Some 2,000 institutions, including those that use the authority today and those that may in the future, would suffer. The Coalition vigorously opposes this provision and urges you to support efforts to defeat it.

The bill would seriously disrupt existing consumer and business relationships and cause serious economic losses. Unitary holding companies (i.e., those that own a single savings institution) that are involved in broader activities would have to divest either their savings institution or other businesses. All savings institutions would lose important business options and could no longer attract private capital from outside the industry through merger or acquisition. It is important to note that the unitary holding company option is available to all savings institutions, whether insured by the FDIC's Bank Insurance Fund or Savings Association Insurance Fund, that meet the housing-oriented qualified thrift lender test. The loss of access to capital would be particularly damaging to SAIF-insured institutions that will soon be paying much higher deposit insurance premiums than BIF institutions.

This new prohibition against unitary activities would not serve any public policy interest and would harm consumers by denying them competitive services. Existing law fully protects the safety and soundness of FDIC-insured institutions and unitary holding companies have maintained the financial health of FDIC-insured affiliates. In fact, diversified companies have infused billions of capital into savings institutions and continue to do so. Please review the enclosed paper that expands on these concerns.

The prohibition on unitary holding company activities is unjustified and would cause tremendous harm. Please do what you can to prevent it from becoming law.

Sincerely,

America's Community Bankers, 900 19th Street, Suite 400, Washington, D.C.

Alabama League of Savings Institutions

California League of Savings Institutions

Ninth Ward Savings Bank, FSB, Wilmington, DE

Prudential S&L, Atlanta, Georgia

Defend Unitary Activities Coalition
February 16, 1995
Page 2

American Savings Bank, FSB, Honolulu, Hawaii

Illinois League of Financial Institutions (serving 140 savings institutions with assets of $40 billion)
Hinsdale Federal Bank, Hinsdale, Illinois
Mid America Federal Savings Bank, Clarendon Hills, Illinois

Indiana League of Savings Institutions, Inc.

Iowa League of Savings Institutions
Citizens Federal Savings Bank, Davenport, Iowa
Midland Savings Bank, FSB, Des Moines, Iowa (a Subsidiary of American Mutual Life Insurance Company, Des Moines, Iowa)
Midwest Heritage Bank, FSB, Chariton, Iowa (a Subsidiary of Hy-Vee Food Stores, Inc.)

Kansas-Nebraska-Oklahoma League of Savings Institutions
Landmark Federal Savings Bank, Dodge City, Kansas

Kentucky League of Savings Institutions, Inc.

Louisiana League of Savings Institutions

Maryland League of Financial Institutions

Community Bank League of New England
Boston Federal Savings Bank, Burlington, Massachusetts

Michigan League of Savings Institutions

Minnesota League of Savings & Community Bankers
Community Federal Savings & Loan Assn., Little Falls, Minnesota
First State Federal, FSB, Hutchinson, Minnesota

Magnolia Federal Bank for Savings, Hattiesburg, Mississippi

Missouri League of Savings Institutions
Heartland Savings Bank, FSB, St. Louis, Missouri
ITT Financial Corp., St. Louis, Missouri

New Jersey Savings League
First Savings Bank of Little Falls, FSB, Little Falls, New Jersey
First Savings Bank, S.L.A., Perth Amboy, New Jersey
First Financial Savings Bank, S.L.A., Woodbridge, New Jersey

Community Bankers Association of New York State

Ohio League of Financial Institutions
Security Federal S&L Assn. of Cleveland, Mayfield Heights, Ohio

Oregon League of Savings Institutions

Star Savings Bank, Bethlehem, Pennsylvania

Community Financial Institutions of South Carolina
The Poinsett Bank, FSB, Travelers Rest, South Carolina

Texas Savings & Community Bankers Assn.

Acacia Federal Savings Bank, Annandale, Virginia
Co-operative Savings Bank, FSB, Lynchberg, Virginia

Washington Savings League

Wisconsin League of Financial Institutions
Baraboo Federal Bank, FSB, Baraboo, Wisconsin

DEFEND UNITARY ACTIVITIES COALITION

February, 1995

The Financial Services Competitiveness Act (H.R. 18) would repeal the ability of a savings institution to be part of a holding company that includes non-financial businesses. A holding company that owns both a single savings institution (a unitary holding company) and is involved in broader activities would have to immediately divest either the savings institution or the other businesses. All unitary holding companies would lose valuable business options.

The new prohibition would not serve any public policy interest.

Savings institutions have affiliated with non-financial firms for decades. These Congressionally permitted affiliations have not caused any problems for consumers or the government.

Concern over the combination of "banking" and commerce -- that depository institutions affiliated with commercial firms would discriminate against competitors -- is overstated. Savings institutions have very limited commercial lending authority, and they may only affiliate with non-financial companies if they meet a strict "qualified thrift lender (QTL) test." That requires them to devote the great majority of their lending to housing.

In fact, concern over affiliation with commercial firms is overstated even with respect to commercial banks, given the massive replacement of bank lending by commercial paper and corporate debt issuances.

The prohibition will harm consumers.

Consumers in communities throughout the country enjoy the convenient and competitive services these companies provide. Many offer one-stop shopping that is particularly valuable to increasingly busy customers. Splitting these companies apart would end many of these customer relationships.

The law already protects consumers and the FDIC.

Savings institutions and their affiliates are governed by strict laws that protect consumers from any unfair marketing practices.

Regulatory agencies must ensure that holding companies have the management and financial strength to operate FDIC-insured affiliates in a safe and sound manner.

Diversified companies have put billions of capital into savings institutions.

Affiliated companies have sought to fully protect the financial health of federally insured savings institutions. They have remained well-capitalized. This provides an extra measure of financial safety to protect the FDIC and the taxpayers. The government should not impose forced divestiture on these responsible corporate citizens.

Companies of all sizes would have to divest at fire-sale prices.

By imposing divestiture the government would throw many institutions of all sizes on the auction block at the same time. Responsible holding companies and their individual shareholders would lose tremendous amounts. Speculators would get a windfall.

All unitary holding companies would lose important business options. Capital would flee savings institutions.

Defend Unitary Activities Coalition
Supplemental
March 3, 1995

Morgan County Federal S&L Assn., Ft. Morgan, Colorado

Essex Savings Bank, Essex, Connecticut
Liberty Bank, Middletown, Connecticut
The New Haven Savings Bank, New Haven, Connecticut
Shelton Savings Bank, Shelton, Connecticut

Florida Bankers Association
Peoples First Financial S&L Assn., Panama City, Florida

Clayton County Federal S&L Assn., Jonesboro, Georgia

Citizens Savings Bank, FSB, Normal, Illinois

Fidelity Federal Bancorp, Evansville, Indiana
First Indiana Bank, Indianapolis, Indiana

East Boston Savings Bank, East Boston Massachusetts
Foxboro Federal S&L Assn., Foxboro, Massachusetts
Stoneham Savings Bank, Stoneham, Massachusetts

Grand Bank for Savings, Hattiesburg, Mississippi
Laurel Federal S&L Assn., Laurel, Mississippi

Nebraska League of Savings Institutions

Community Bankers Association of North Carolina
Home Federal S&L, Charlotte, North Carolina
Macon Savings Bank, SSB, Franklin, North Carolina
First Federal S&L Assn. of Lincolnton, Lincolnton, North Carolina
Mooresville Savings Bank, SSB, Mooresville, North Carolina
Home Savings Bank of Siler City, SSB, Siler City, North Carolina

Germantown Federal Savings Bank, Germantown, Ohio

Iron Workers Savings Bank, Aston, Pennsylvania
Bridgeville Savings Bank, Bridgeville, Pennsylvania
Charleroi Federal Savings Bank, Charleroi, Pennsylvania
Corry Savings Bank, Corry, Pennsylvania
First Federal S&L, Hazleton, Pennsylvania
Abington Savings Bank, Jenkintown, Pennsylvania
Parkdale Financial Corp., Monroeville, Pennsylvania
First Federal Savings Bank, Monessen, Pennsylvania
Third Federal Savings Bank, Newtown, Pennsylvania
United Savings Bank, Philadelphia, Pennsylvania
Workingmen's Savings Bank, FSB, Pittsburgh, Pennsylvania
East Stroudsbury Savings Assn., Stroudsburg, Pennsylvania
MLF Bancorp, Inc., Villanova, Pennsylvania

Defend Unitary Activities Coalition
Supplemental
March 3, 1995

Virginia Bankers Association
Mutual Savings Bank, FSB, Danville, Virginia
Washington Federal Savings Bank, Herndon, Virginia
Fidelity Federal Savings Bank, Richmond, Virginia
SWVA BancShares, Inc., Roanoke, Virginia

Beckley Federal Savings Bank, Beckley, West Virginia

Tri-County Federal Savings Bank, Torrington, Wyoming

NEWS FROM Congressman John J. LaFalce
29th District, New York

CONTACT: Gary Luczak
(202) 225-3231

FOR IMMEDIATE RELEASE:
March 2, 1995

Statement of
Hon. John J. LaFalce (D-29, NY)

ON GAO REPORT ON BIF-SAIF PREMIUM DIFFERENTIAL

This is a complex report about a complex topic. But it makes one thing perfectly clear. Taking no action is not an option. Our goal must be to avoid any use of taxpayer funds now or in the future, and to achieve that goal we must act.

This report makes it clear that the premium differential, coupled with the enormous burden imposed by the FICO bond obligation, could place thrifts at a significant competitive disadvantage, hampering the industry's recovery. We cannot afford to take the risks of a thinly capitalized fund, a substantial decline in the deposit base, or an inability of the industry to raise capital that the report emphasizes are very real. The industry will not stand still in the face of a serious competitive disadvantage, as today's announcement that Great Western will seek a bank charter points out.

The FDIC and the Administration must move quickly to recognize the seriousness of this problem and recommend solutions. While preliminary efforts are underway, I believe it is critical that they move quickly. Otherwise the Congress will be required to proceed independently, I would hope on a bipartisan basis, to address the problem without benefit of their input.

NEWS

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, WASHINGTON, D.C. 20510-6075

FOR IMMEDIATE RELEASE:
Thursday, March 2, 1995

CONTACT: Chris Staszak 202-224-0894
Harvey Valentine 202-224-6498

D'AMATO, LAFALCE SAY GAO REPORT SHOWS RISKS TO THRIFT INDUSTRY

WASHINGTON-- U.S. Senator Alfonse M. D'Amato (R-NY) and Congressman John J. LaFalce (D-NY-29) today announced the findings of a General Accounting Office (GAO) analysis which they say shows that the potential disparity in the insurance premiums between banks and thrifts poses substantial risks to the thrift industry and to taxpayers. The lawmakers said that Congress and the Administration must take early action to address this long-term problem.

"I am concerned that another thrift crisis is looming on the horizon," said D'Amato, Chairman of the Senate Banking Committee. "This poses an ominous development for the American taxpayer if Congress is not able to correct this potential problem."

LaFalce, a member of the House Banking Committee and its Subcommittee on Financial Institutions, noted that: "This is a complex report about a complex topic. But it makes one thing perfectly clear. Taking no action is not an option. Our goal must be to avoid any use of taxpayer funds now or in the future, and to achieve that goal we must act."

In June 1994, Senator D'Amato and Congressman LaFalce requested that the GAO analyze the issues related to the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

"We must protect American taxpayers who have already poured $150 Billion into the savings and loan rescue," D'Amato said. "The safety and soundness of the insurance funds for banks and thrifts as well as the competitiveness of the thrift industry remains a high priority for our committee."

Yesterday, one of the nation's largest thrifts applied for a bank charter citing the potential premium differential.

"We cannot afford to take the risks of a thinly capitalized fund, a substantial decline in the deposit base, or an inability of the industry to raise capital that the report emphasizes are very real," LaFalce said.

A copy of the report and the letters requesting it are attached.

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America's Community Bankers

CONGRESS NEEDS TO PREVENT A BIF/SAIF PREMIUM DISPARITY

Institutions insured by the Savings Association Insurance Fund will soon have to pay much higher deposit insurance premiums than competing organizations insured by the Bank Insurance Fund. Savings institutions' customers, their communities, and ultimately the taxpayers, would bear the brunt of this disparity. In the mid-1980s, the thrift industry was criticized for not forewarning Congress of the magnitude of the impending S&L crisis. Now, 10 years later, we don't want a similar situation to occur. It is urgent that Congress deal quickly with this problem to prevent new difficulties and maintain financial stability.

BIF Premiums to Fall - SAIF Premiums Will Stay High

Members of the FDIC's Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) now pay an average of 24.5 basis points (cents per $100) for deposit insurance. In 1995 BIF premiums will likely drop substantially because BIF will reach its statutory target of 1.25 percent of insured deposits. The FDIC has proposed that BIF members' rates fall to an average of 4.5 basis points in 1995 -- an 83 percent decrease -- while SAIF institutions will continue to pay 24.5 basis points through 2002. That is the earliest that SAIF can reach 1.25 percent.

SAIF Members Could Have Recapitalized The Fund

If SAIF premiums had been used strictly for deposit insurance savings institutions could have capitalized the fund by 1994. SAIF has fallen behind because $7.4 billion of premiums paid since 1989 were diverted to the Resolution Trust Corporation (RTC) and related agencies and used to pay interest on 30-year Financing Corporation (FICO) bonds.

FICO payments consume 44 percent of SAIF's annual premiums, nearly $800 million. Under current conditions, SAIF premiums must remain 11 basis points higher than BIF premiums until 2019 just to pay FICO interest.

The Premium Disparity Will Be Disruptive

The disparity could quickly lead to serious problems:

- choke off housing and consumer credit;
- create a new universe of problem institutions;
- erode the strong capital base built by savings institutions; and,
- require that taxpayers again pay off depositors.

Higher premiums are like a higher tax rate on SAIF-insured institutions. For example, a 20 basis point disparity would cost as much as an additional 15 percent tax. This will make it hard for SAIF members to maintain their capital—the first line of defense for the FDIC and the taxpayers.

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SAIF members provide consumer financial services in more than 12,500 offices nationwide and employ more than 217,600 people. They specialize in home finance and, as of June, 1994 held $472 billion in mortgage loans, plus $177 billion in mortgage securities. Weaker institutions will be less able to provide these valuable services.

SAIF members will decrease reliance on SAIF deposits. As a result, SAIF's premium income will fall, undermining its ability to protect depositors and pay the FICO interest. Taxpayers could be asked to make up the shortfall. Depositors would again have to worry about the safety of their savings.

Solutions

Resolving the BIF/SAIF premium disparity problem is ACB's #1 priority. In working to solve this problem ACB will be guided by the following principles:

- ACB wants premiums for all BIF and SAIF institutions to drop as far as they can as quickly as they can.
- Although it is ACB policy that a merger of the BIF and SAIF insurance funds is an appropriate approach to resolving the premium disparity problem, such a merger may not be necessary if the following conditions are met:
- SAIF-member institutions accept their ongoing responsibility to continue to recapitalize their own insurance fund.
- SAIF shares FICO costs with BIF on a pro rata basis.
- Excess RTC funds, at a minimum, remain available in an amount sufficient to cover potential insurance fund losses at SAIF-insured institutions identified by their primary federal regulator as problem institutions as of December 31, 1997.
- SAIF-insured institutions pay a premium differential relative to BIF-insured institutions of five basis points until the fund reaches the 1.25 percent ratio.

Congress Should Act Now

Congress has time—but not much time—to act. The premium disparity will become a reality by the end of 1995. However, at the capital market level institutions are already being affected. Their customers and communities will soon follow. In the 1980s, many in Congress expressed their frustration with the industry for not having forewarned them of an impending problem. Today the savings institution industry is alerting Congress to a problem that is beginning to affect the industry now and may have serious economic consequences in the next 4-5 years. Congress should take early action to reassure insured institutions, the markets, and—most importantly—depositors and taxpayers that it will maintain a stable financial system.

QUESTIONS AND ANSWERS ABOUT THE BIF/SAIF PREMIUM DISPARITY

Q. Why should Congress be concerned about the premium disparity?

A. The disparity could quickly lead to serious problems:

- **choke off housing and consumer credit;**
- **create a new universe of problem institutions;**
- **erode the strong capital base built by savings institutions; and,**
- **require that taxpayers again pay off depositors.**

Higher premiums will be like a higher tax rate on SAIF-insured institutions. For example, a 20 basis point disparity would cost as much as an additional 15 percent tax. This will make it hard for SAIF members to maintain their capital—the first line of defense for the FDIC and the taxpayers.

SAIF members provide consumer financial services in more than 12,500 offices nationwide and employ more than 217,600 people. They specialize in home finance and, as of June, 1994 held $472 billion in mortgage loans, plus $177 billion in mortgage securities. Weaker institutions will be less able to provide these valuable services.

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Q. Doesn't the FDIC insure deposits in all banks and savings institutions; what's this about two funds?

A. In 1989 Congress gave the FDIC deposit insurance responsibility for savings institutions. But instead of simply establishing a single fund for all FDIC-insured institutions, Congress established a new Savings Association Insurance Fund (SAIF) and renamed the original FDIC fund the Bank Insurance Fund (BIF).

Q. Why didn't Congress create just one fund?

A. Commercial banks insisted on separate funds. Ironically, in 1991 GAO determined BIF was insolvent. The Treasury Department loaned $13 billion to BIF, since repaid, to maintain its liquidity.

Q. Why is BIF now so much stronger than SAIF?

A. The economic recovery and lower interest rates have led to higher profits and fewer failures for BIF and SAIF members alike. BIF has benefited more than SAIF, however, since its premiums have been strictly devoted to paying its relatively low deposit insurance costs. As of September 30, 1994, BIF had $19.4 billion in reserves, 1.03 percent of insured deposits.

In contrast, $7.4 billion of SAIF premiums paid since 1989 were diverted to the Resolution Trust Corporation (RTC) and used to pay interest on 30-year Financing Corporation (FICO) bonds. FICO payments consume 44 percent of SAIF's annual premiums, nearly $800 million. Like RTC funds, FICO bond proceeds were used to pay depositors in closed savings and loan associations.

So, instead of building reserves for the future, much of SAIF's income was used to pay for past failures. As of September 30, 1994 SAIF had $2.01 billion in reserves, 0.29 percent of insured deposits.

.lso, SAIF has grown slowly because SAIF-insured institutions did not experience the 7 percent annual deposit growth that Congress expected. In fact, SAIF-member deposits shrank by 9.2 percent annually from 1989 through mid-1993. The shrinkage continued through mid-1994, with deposits falling 4.1 percent.

Q. Did Congress have a plan to help SAIF get on its feet?

A. Congress knew that SAIF could not bear the burden of the past and build strength for the future, and so planned to appropriate seed money for the fund. Unfortunately, Congress did not carry out these plans because SAIF funding got swept up in the RTC issue.

Q. What can Congress do to eliminate the disparity?

A. Resolving the BIF/SAIF premium disparity problem is ACB's #1 priority. In working to solve this problem ACB will be guided by the following principles:

- ACB wants premiums for all BIF and SAIF institutions to drop as far as they can as quickly as they can.

- Although it is ACB policy that a merger of the BIF and SAIF insurance funds is an appropriate approach to resolving the premium disparity problem, such a merger may not be necessary if the following conditions are met:

- SAIF-member institutions accept their ongoing responsibility to continue to recapitalize their own insurance fund.

- SAIF shares FICO costs with BIF on a pro rata basis.

- Excess RTC funds, at a minimum, remain available in an amount sufficient to cover potential insurance fund losses at SAIF-insured institutions identified by their primary federal regulator as problem institutions as of December 31, 1997.

- SAIF-insured institutions pay a premium differential relative to BIF-insured institutions of five basis points until the fund reaches the 1.25 percent ratio.

Q. Why should Congress allow the continued use of RTC money to help SAIF?

A. Congress realized in 1989 that SAIF could not pay interest on FICO bonds, help fund the RTC, and recapitalize itself without assistance. So, it intended to appropriate money to SAIF. Congress did not do so, but did provide a way for unused RTC money to be used for SAIF. Using RTC funds to assist SAIF would be consistent with Congress' original intention.

Q.* The FDIC has said that the SAIF insurance premiums it collects from so-called "Oakar banks" (that is, institutions that resulted from a savings institution-bank combination) and "Sasser banks" (that is, savings institutions that have converted to commercial banks and state savings banks) are not subject to the FICO draw against SAIF assessments. Would the SAIF funding problem be solved if Congress simply required that Oakar and Sasser banks' insurance premiums be used in part to pay FICO interest?

A.* Requiring Oakar and Sasser banks to contribute to FICO payments will not rectify the SAIF's fundamental problem, i.e. total SAIF assessment income is shrinking, leaving less and less income for the SAIF after the FICO draw. The real problem, from the perspective of the SAIF, is not that assessments on Oakar and Sasser deposits are unavailable to FICO, but that overall SAIF deposits are declining rather than growing as assumed in FIRREA, causing the relative size of FICO's draw to grow as a percentage of SAIF assessments. Moreover, the impending SAIF/BIF premium differential is likely to accelerate SAIF shrinkage, thereby increasing the proportion of FICO's draw on SAIF assessments.

Q.* If the number of thrifts projected to fail in the near term is relatively low and SAIF assessments are, for now, sufficient to service the FICO debt, than why not wait and address this issue when the need becomes more urgent?

A.* Current projections about savings institution failure are based on what is now known and on what can reasonably be predicted for the near term. What we do know for certain is that the SAIF has less than one-fourth the level of reserves that Congress judged necessary for the fund to withstand significant pressure. We know that the SAIF is undercapitalized and that, even under the most optimistic projections, it will not fully capitalize until the year 2002. By postponing a solution to the SAIF capitalization issue, we take on the risk that unforeseen events will tax the SAIF beyond its limit before the issue can be resolved. One lesson of the savings and loan crisis is that the costs to the government and the taxpayer of such a postponement strategy can easily dwarf the costs of an early resolution.

Q. Wouldn't sharing the FICO costs require banks to pay for problems they didn't cause?

A. The SAIF institutions that are still in business are no more responsible for these problems than the BIF members. SAIF institutions' customers and their communities should not suffer from a premium disparity that they didn't create. At the same time, BIF members will benefit from a stable, equitable deposit insurance system.

Q. Why should BIF members accept sharing FICO costs?

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*Adapted from: Questions and Answers on Status of the Savings Association Insurance Fund and Potential Premium Disparity with the Bank Insurance Fund. Office of Thrift Supervision, February 3, 1995.

A. BIF members depend on public confidence in federal deposit insurance. Eliminating the premium disparity would avoid disruptions and help maintain public confidence. BIF members will benefit from a more stable BIF.

There are nearly 700 BIF-insured commercial banks with SAIF deposits acquired through mergers and acquisitions. They have a direct interest in eliminating the disparity since they will pay the higher SAIF premium on those deposits. In fact, commercial banks and their subsidiaries hold more than 25 percent of all SAIF deposits. An equitable premium structure would directly help these institutions.

Q. Do savings institutions have some advantages over banks that help make up for the premium disparity?

A. Generally not. They pay approximately the same effective tax rate. Federally chartered SAIF members may now branch interstate (though few have), while BIF members will gain that power in less than three years under the new interstate banking and branching law. In 1995, BIF members will have more liberal interstate acquisition power than SAIF members, since all state restrictions on BIF-member acquisitions will be preempted.

The vast majority of savings associations - nearly 1800 - are affiliated only with firms that engage in activities also permitted for bank holding companies. As of 1993, only 40 were affiliated with diversified companies, a form of ownership not permitted for banks. While savings associations have some broader insurance and real estate development authority than banks, many banks are gaining insurance powers through regulatory actions and state laws. On the other hand, banks have much broader commercial lending powers than savings institutions and have a lower cost of funds because they do not pay interest on a significant portion of their core deposits.

If savings associations actually had significant advantages over commercial banks, one would expect many banks to change charters, since they could retain their BIF membership. However, such conversions have been very rare.

America's Community Bankers

DANGERS OF A "DO NOTHING" APPROACH TO SAIF

SAIF, under current law, is required to be capitalized at 1.25 percent of insured deposits. At the same time, 45 percent of SAIF premiums, nearly $800 million a year, is diverted to service FICO bonds. That obligation runs to 2019.

Because BIF is expected to recapitalize later this year and bears no part of the FICO obligation, BIF premiums will drop to 4 basis points under the FDIC's plan. SAIF premiums are to stay at about 24 basis points.

Can SAIF-insured institutions sustain a differential that large, continue to recapitalize SAIF and service the FICO debt without compromising safety and soundness?

It would be foolish to think managers and directors of SAIF-insured institutions won't react to this premium disparity. From a purely competitive standpoint, their income and capital will be threatened. To reduce premium costs, they may switch from retail deposits to other sources of funds. To accommodate higher costs, they may seek higher-yielding, higher-risk assets. In short, real world, market-driven behavior will affect the future of the SAIF assessment base, premium income, and potential insurance fund losses.

SAIF INSOLVENCY?

The table illustrates the vulnerability of SAIF as deposits shrink and losses grow. A substantial premium differential could easily cause SAIF deposits to shrink at close to the 6 percent annual rate recorded between 1989 and 1994. To the extent that SAIF institutions stretch for yield, loss exposure will increase. These are plausible results of the premium differential and they could leave SAIF insolvent by 2004. **SAIF might never recapitalize** and its weak condition would pose a threat to the financial system. The chart illustrates that the SAIF assessment base is currently only about half the amount that Congress assumed in 1989 would now be available to support the insurance fund and service FICO debt. The chart shows the situation is likely to worsen each year.

CRISIS: FICO FIRST?

Unless the law is changed, the annual diversion of some $800 million in SAIF premiums to service FICO will keep SAIF premiums high and could eventually bankrupt SAIF. But FICO could default on its bonds even before SAIF is in crisis. That's because about 30 percent of SAIF deposits, those held by Oakar* and Sasser** banks, are not subject to the FICO obligation. So at some point, SAIF may be able to cover its losses but might not have enough money to pay FICO, particularly if deposits shrink. Unless these funding problems are addressed, SAIF may have sufficient income to cover losses but insufficient income to pay FICO, creating a FICO debt service crisis as soon as 1998.

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The fact that FICO debt service must be paid only from premium income on SAIF deposits at savings associations, not from SAIF-insured deposits at Oakar and Sasser banks, makes a crisis that much more likely to occur. The chart indicates that if SAIF-insured deposits decline at a 6 percent rate as previously assumed, and Oakar and Sasser bank deposits grow modestly from $217 billion to $260 billion, only about $300 billion of a total of $560 billion in SAIF-insured deposits will be available to service FICO debt in 1998. An attempted quick fix that simply makes premiums from Oakar and Sasser banks available to pay the FICO debt does not solve the fundamental problem: a fixed burden on a shrinking base.

Assuming that SAIF insurance premiums are held at 24 basis points, by 1998 FICO debt service will consume more than 100 percent of available premium income. This shortfall of funds available for FICO payments could be addressed by increases in insurance premiums to levels above 24 basis points. However, such increases would precipitate an even more rapid decline of the SAIF assessment base, and still trigger an eventual default on the FICO bonds.

A SOLUTION

Providing a reasonable and rational solution to recapitalizing SAIF and addressing the FICO burden is in the interest of the entire banking community, as well as the customers they serve. America's Community Bankers has crafted a proposal which we believe sets an appropriate framework for such a solution. The elements are:

1. ACB is committed to achieving a reduction in premiums for all BIF- and SAIF-insured banks and savings institutions as much and as quickly as possible.

2. ACB believes that a merger of the insurance funds is an appropriate approach to resolving the premium disparity problem, but that such a merger not be necessary under the following conditions:

   - SAIF-insured members continue to recapitalize their own fund.
   - SAIF and BIF insurance funds will share the FICO burden on a pro rata basis.
   - Excess RTC funds, at a minimum, will remain available in an amount sufficient to cover potential insurance fund losses at SAIF-insured institutions identified by their primary regulators as problem institutions as of December 31, 1997.
   - SAIF-insured institutions will pay a premium differential (5 basis points) relative to BIF-insured institutions until the SAIF fund reaches the required 1.25 percent reserve ratio.

* An Oakar bank is a commercial or savings bank that has acquired deposits from SAIF insured institutions.

** A Sasser bank is a commercial or savings bank that has converted from a savings association charter.

Contact: Robert R. Davis - (202) 857-3161

What Happens to SAIF with a "Do – Nothing" Approach
Savings Association Insurance Fund Financial Projections
($ millions)

Assumptions: No change in SAIF funding structure; average SAIF premium rate held at 24 basis points; BIF premium falls to 4 basis points; SAIF deposits contract at a 6% annual rate; SAIF closure costs and expenses escalate; fund balance earns 5.5% compounded continuously.

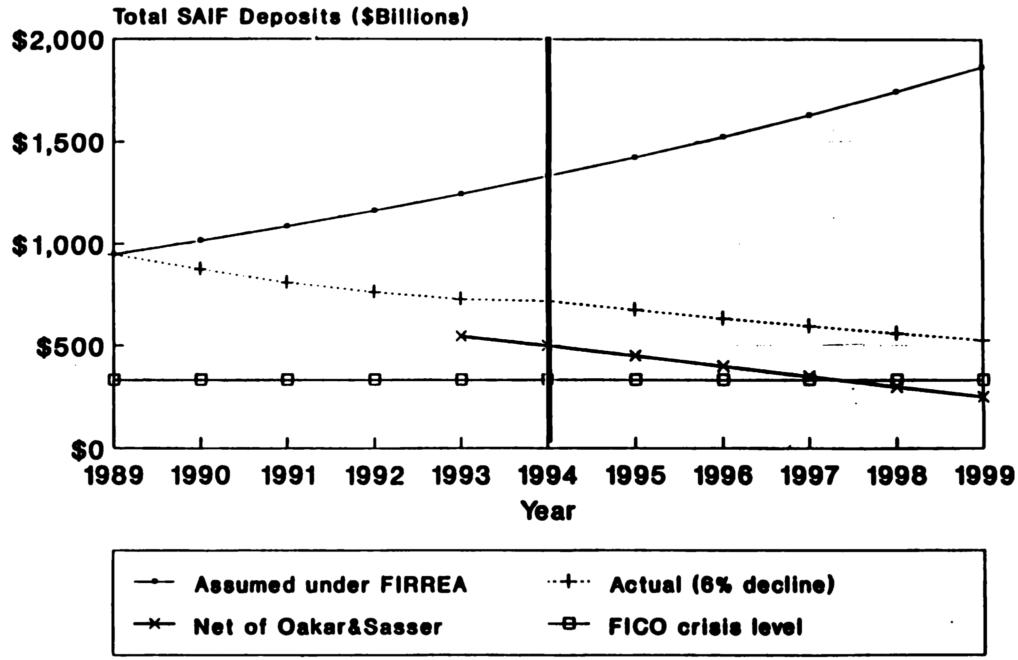
Date	Insured Deposits	Premium Income	FICO Payments	SAIF Closure Costs & Expenses	Fund Balance	Reserve Ratio
9/30/94 *	$687,321	$1,720.5	$793	$55	$2,011.0	0.29%
9/30/95 **	$646,082	$1,617.2	$793	$265	$2,683.9	0.42%
9/30/96	$607,317	$1,520.2	$793	$375	$3,187.9	0.52%
9/30/97	$570,878	$1,429.0	$793	$635	$3,369.1	0.59%
9/30/98	$536,625	$1,343.2	$793	$895	$3,214.8	0.60%
9/30/99	$504,428	$1,262.6	$793	$1,000	$2,866.3	0.57%
9/30/00	$474,162	$1,186.9	$793	$1,000	$2,422.2	0.51%
9/30/01	$445,712	$1,115.7	$793	$1,000	$1,881.8	0.42%
9/30/02	$418,970	$1,048.7	$793	$1,000	$1,244.0	0.30%
9/30/03	$393,831	$985.8	$793	$1,000	$507.1	0.13%
9/30/04	$370,201	$926.7	$793	$1,000	($330.6)	–0.09%

* SAIF assessment base represents total domestic deposits of approximately $557 billion in SAIF member institutions, $167 billion in Oakar deposits, and $1.6 billion in RTC conservatorships, excluding $8.6 billion in reverse Oakar deposits.

** Estimated date for Bank Insurance Fund balance to reach 1.25% of deposits, triggering a BIF premium drop to 4 basis points. SAIF premium remains at 24 basis points, creating 20 basis point differential.

Source: America's Community Bankers.

SAIF Deposit Trends



Sources: America's Community Bankers; FDIC.

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COMMENTS ON THE PREMIUM DISPARITY

FDIC Chairman Helfer:

Helfer: "A substantial premium differential between BIF-insured and SAIF-insured institutions is likely to have an impact--and FDIC Board members know that....I want to stress that the problem will not just go away....[The] draw on the SAIF...to service bonds issued by the Financing Corporation, known as "FICO" bonds...is about $780 million a year. If you have ever tried to fill a bucket with a big hole in the side, you see the problem here....The insurance system for the savings and loan industry may no longer by broken, but it still needs fixing....If I were a banker, I would not close my eyes to the SAIF problems and hope they magically disappear. I would involve myself in working with all the interested parties to make sure that the inevitable solution is both effective and fair."

New York State Bankers Association; February 2, 1995.

Federal Reserve Chairman Greenspan, Acting OTS Director Fiechter, and FDIC Vice Chairman Hove before the Senate Banking Committee:

Greenspan: "If you get a competitive disparity of significant order of magnitude, you create a situation in which you have a movement out of the savings and loan industry, fewer resources within the SAIF fund. Since the FICO bonds are a fixed cost . . . you run into the continuous pressure where you have a significant fixed cost, but the resources decline—I think that it's quite important that this issue be resolved."

* * * * * * *

Fiechter: "This higher premium is likely to discourage investors from putting capital into SAIF-insured institutions. If this is allowed to occur, it will be harder for healthy SAIF-insured institutions to raise new capital; the resolution of problem institutions will be more expensive for the government; SAIF income will decline further; and the credit markets will, increasingly, see a diminution in a dedicated source of housing finance . . . In certain key markets, savings associations are leaders in meeting the housing finance needs of minorities and low-income persons and make such loans at a higher rate than other depository . . . seven of the 12 largest lenders to minority and low-income areas in California are savings associations, and savings associations there have much lower denial rates for African Americans and Hispanics than any other type of lender."

* * * * * * *

Hove: "It is an issue that is coming very soon . . . a merger of the fund or a sharing of the FICO obligation by institutions that really had nothing to do with it, is imposing a tremendous burden on those institutions. But the burden is there. And I guess you could make the same argument that the thrifts that remain, clearly, were not part of the problem either. They are the healthy thrifts that have remained, like the healthy banks . . . There are some alternatives . . . one of these alternatives is the merger of the funds. There may be some other alternatives . . . but it's an issue that I think is going to be—need to be addressed very soon next year."

Senate Banking Committee Hearing; September 22, 1994.

Congressional Budget Office:

"The Congressional Budget Office, along with most other analysts of the nations's banking and thrift institutions, expects that institutions insured by the Bank Insurance Fund and the Savings Association Insurance Fund (SAIF) will pay significantly different rates for the federal deposit insurance beginning in 1995. In combination with other factors, this cost difference could lead to a situation wherein premiums paid to the SAIF would not be adequate to cover future insurance fund losses, interest payments on bonds of the Financing Corporation, or both."

Congressional Budget Office, Memorandum to House Banking Committee; October 14, 1994.

Senator Christopher J. Dodd (D-CT):

"When the Bank Insurance Fund is fully capitalized—possibly as soon as a year from now—SAIF-insured institutions will face a serious competitive disadvantage. Although no one could have predicted the pace at which the thrift industry would shrink or the astounding pace at which the BIF would be recapitalized, this is a problem Congress should have better anticipated."

Annual Convention, SCBA [Since renamed America's Community Bankers]. Orlando; October 19, 1994.

William Seidman, FDIC chairman in Bush Administration:

"'It would be a disaster for the S&L industry. They can't compete for very long with those differences,' Seidman said, speaking at a meeting of Women in Housing and Finance. Seidman said the only solution he can see would be to recapitalize the Savings Association Insurance Fund with funds authorized for but not spent by the Resolution Trust Corporation, as it closes out its tenure as the thrift cleanup agency. About $8 billion is expected to remain unspent."

The Bureau of National Affairs, Inc. BNA's Banking Report; September 26, 1994.

Acting OTS Director Fiechter:

"An insurance fund that makes thrifts uncompetitive can't work. Over the past few years we've seen private money come in to recapitalize thrifts. But with the premium differential between banks and thrifts making thrifts uncompetitive, we will see that private capital dry up . . . I don't believe that repayment of the FICO bonds has anything to do with insuring current deposits at thrifts. And if this burden on the fund causes it to fail then the SAIF fund will not stop functioning as a deposit insurance fund but as a financing mechanism for FICO as well."

American Banker-Bond Buyer. American Banker Washington Watch; September 26, 1994.

Acting OTS Director Fiechter:

"The assumptions inherent in the FDIC staff proposal – that the rapid decline in the SAIF assessment base experienced over the last three years will slow, and that the rate of losses in the thrift industry in the future will be significantly below that experienced over the last 15 years – may not hold...If these assumptions are in error, the prediction by the FDIC staff that SAIF will capitalize in the year 2002 also doesn't hold...The obvious solution to this problem is to develop an alternate mechanism to fund FICO that does not place the entire burden on a shrinking portion of the thrift industry."

OTS News Release; January 31, 1995.

Florida Bankers Association:

"Presently, all federally-insured depository institutions utilize an identical schedule of deposit insurance premiums. **Florida bankers hold the view that all federally-insured depository institutions should remain subject to a risk-adjusted deposit insurance premium schedule which, if not identical, does not present significant differences in insurance premiums for institutions representing similar risks."**

One element of FBA's current position on the impending BIF/SAIF disparity. Approved by the Board of Directors December 9, 1994.

FY 1996 Clinton Administration Budget

"First, the impending reduction in the BIF premium could create additional earnings pressure for the thrift industry and **further aggravate the financial condition of the thrift insurance fund, the Savings Association Insurance Fund....[T]he downside risks to the thrift industry could be significant and deserve attention."**

[Emphasis added]

Testimony

of the

Consumer Bankers Association

before the

Committee on Banking and Financial Services

U.S. House of Representatives

on

H.R. 1062

The Financial Services Competitiveness Act of 1995

March 7, 1995

Mr. Chairman and members of the Subcommittee, my name is Allen Croessmann. I am the Director of Mutual Funds for Bank of Boston. I also serve on the Retail Investments Committee of the Consumer Bankers Association ("CBA").

I appreciate this opportunity to appear before the Committee on behalf of the CBA to testify on the need for legislation to reform the regulatory framework governing the role of banks in the financial services industry.

The CBA was founded in 1919 and represents approximately 750 federally insured banks and thrift institutions holding more than 80 percent of all consumer deposits. Our membership includes regional, superregional, and money center banks, a majority of which offer investment products to their retail customers. The CBA focuses on promoting the ability of its members to offer retail financial products and services to the public.

In 1983, when CBA testified before this Committee, we asked you to consider as a principle for reform the parity of treatment between all types of consumer financial services providers. At that time, we asked you to support interstate banking and the deregulation of bank products and services. We are grateful for the interstate banking bill that passed last year. Since technological, economic, and market changes have effectively turned the Glass-Steagall Act into an anachronism and a barrier to economic growth, we are delighted that legislation to address these problems is the focus of this Committee today.

The CBA Supports Financial Services Reform to Eliminate Artificial Barriers and Enhance the Delivery of Financial Services

Mr. Chairman, the CBA commends you for your leadership in addressing the need for reform of the laws that govern bank participation in the financial services markets. Your bill, H.R. 1062, the Financial Services Competitiveness Act of 1995, is an important step toward removing some of the excessive regulations that encumber banks as financial services providers. The CBA applauds your initiative and we appreciate this opportunity to testify.

The CBA supports reform of the Glass-Steagall Act and the provisions in the Bank Holding Company Act that impose artificial restrictions on the ability of banking organizations to provide a full range of financial services to their customers. These laws are antiquated and impede the ability of banks to provide financial services to their customers competitively, conveniently, and efficiently. We applaud the provision in H.R. 1062 that would broaden the standard for permissible activities of financial services holding companies to those that are "financial in nature" and that would significantly reduce the notice procedures for such activities.

Insurance and securities are clearly viewed by the financial markets and the public as financial products. Banks, as financial institutions, are natural channels for delivering these products.

While banks have made substantial progress in finding ways to respond to customer demands for securities and insurance products within the statutory limits of the Glass-Steagall Act and the Bank Holding Company Act, these laws impose extremely cumbersome limitations that make the delivery of these products and services inefficient and costly.

For example, the current cross-marketing firewalls impair customer access to products and services of bank securities affiliates. Restrictions against employee interlocks between banks and their securities affiliates impose operational inefficiencies that raise the cost of financial services for bank customers. On the other hand, we applaud recent Federal Reserve Board actions which permit CBA members to offer discounts on certain packaged financial products and services offered by banks and their affiliates.

Reforming Glass-Steagall is particularly important today because advances in technology permit new competitors to offer financial services. Microsoft, with its purchase of Intuit--a home banking computer company--is an example of the type of competitor that will offer innovative alternatives to traditional banking.

The CBA believes that the focus of financial services regulation should be not on restricting competition but on promoting it. The regulatory aim should be to ensure that financial services are widely available in the most convenient, efficient form consistent with safe and sound practices and due regard for protecting customers.

Legislative Reform Should Enhance the Role of Banks as Full-Service Financial Service Providers

The CBA would ask that any reform legislation adopted by Congress aim to enhance the role of banks as full-service financial service providers. Retail customers already view their local banks as full-service providers of financial products. The days are gone when retail customers saw banks as simply a convenient place to safekeep their deposits and borrow money.

Retail customers can now look to some banks as a source of mutual funds, securities, annuities, investment advice, 401(k) plans, asset allocation plans, life insurance, title insurance, and other financial products and services. These services may now be available through banks either directly or through contractual arrangements with third party service providers who use the bank's premises, office facilities, and often their employees.

It is understandable why this view of banks as full-service providers has emerged. Banks are the most experienced delivery channel for all types of financial services. No other type of financial service provider offers such an extensive delivery network. The convenience of obtaining a wide range of financial services from a single provider is no small benefit for today's busy retail consumers. In addition, ATMs and point of sale (POS) terminals located in supermarkets and other retail outlets offer customers added convenience.

Banks also tend to be not only more accessible but more approachable than many nonbank service providers, such as brokerage firms that traditionally have served wealthy customers. Banks meet the financial needs of all types of consumers, not just the affluent investor. With our experience in dealing with the broader customer market and the delivery system to back us up, we offer the majority of consumers a more accessible and user-friendly way of obtaining financial products and services.

Moreover, as the primary financial institution for a wider customer base, banks play an important role in educating consumers on the advantages and disadvantages of all products available to meet their financial needs. A major part of the marketing efforts of banks today consists of informational programs and materials designed to educate customers on the various features of the many types of products and services available. We have found that an educated consumer is our best customer.

The banking industry has been especially conscious of the possibility for customer confusion regarding uninsured investment products. We have been greatly concerned about reports of customer misunderstandings regarding the risks and uninsured nature of mutual funds. In response to this problem, we have enhanced our education efforts through increased disclosures, both written and verbal, and by emphasizing the importance of customer comprehension.

Three months ago, the CBA released the results of an extensive study by Roper-Starch Worldwide showing

that the overwhelming majority of household financial decision makers understand that mutual funds sold at banks are not FDIC insured. The study, which was commissioned by the CBA, tested for customer comprehension through in-home interviews with 700 randomly selected financial decisions makers with at least $30,000 in annual income. These interviews were supplemented by interviews with 139 randomized bank mutual fund customers from lists supplied by banks. The results showed that, when bank mutual fund customers were asked, as few as five percent said they believed that the funds were FDIC insured. Further, 87 percent said that banks did fairly well or very well in explaining a mutual fund investment.

The CBA and its members are continuing to explore the best ways of communicating investment risks and fees to consumers to avoid customer confusion.

Legislative Reform Should
Enhance the Ability of Banks
to Offer Integrated Services

Mr. Chairman, as you and your Committee consider various reform proposals, the CBA believes it is important to note that advances in communications and computer technology offer banks opportunities to better serve their customers. Banks are finding that their customers have new expectations for efficiency and quality of service in today's market. Technological advances have improved the quality of life for consumers in many ways, and bank customers are demanding that their banks provide the same kind of time-saving products and services that modern technology has made possible in other areas.

Many banks are finding that the most efficient method of customer service that also offers the greatest convenience and quality of service to the customer is an integrated delivery system designed to meet all of the customer's demands for financial services through a single focal point in the bank. Rather than transferring the customer from unit to unit within the bank, many banks are now trying to bring the various units of the bank to the customer. Modern technology in the form of computerized communications and data processing systems are making it possible for banks to provide highly efficient integrated services on a "seamless" basis. These benefits should be enhanced by any Glass-Steagall reform.

This form of customer service benefits the customer in many ways. The number of forms that the customer must fill out may be minimized because various units of the bank could have on-line access to computerized information about the customer. The number of service representatives that the customer must deal with could be reduced. The amount of time the customer must spend waiting for customer service can be minimized. The customer can receive more efficient, individualized attention by the bank's service representatives who can become instantly knowledgeable about the customer's relationship with the various units of the bank. The customer could be offered services that better correspond with the customer's needs. The customer's needs could be anticipated and evaluated in a timely manner so that, for example, the customer could receive timely advice on making financial decisions when a certificate of deposit comes due.

Cross-marketing of products and services among the various units of a banking organization obviously is a critical element to make possible "seamless" delivery of customer services by banking organizations. For example, banks will need to maintain customer information on an integrated basis so that various service units can have access to certain information that can be used to benefit the customer. Because much of this information is confidential, many banks have already adopted policies and procedures for protecting the privacy of their customers.

For this reason, we are looking closely at the firewalls that would be imposed under H.R. 1062, particularly the provision regarding disclosure of confidential customer information. We would like to work with the Committee in making sure that this provision, while respecting customers' privacy, does not create operational problems that would unnecessarily hinder the ability of banks to integrate their services for the convenience of customers.

The CBA is very appreciative that H.R. 1062 would eliminate the cross-marketing restriction imposed by the Federal Reserve that currently prevents banks from making available to their customers securities that are being underwritten by an affiliated securities underwriting company. This restriction has unnecessarily limited customer access to these products and services and its removal will enhance the convenience and availability of financial services to bank customers.

Functional Regulation Should Facilitate
the Integrated Delivery of Financial Services

The CBA believes that the essence of functional regulation is to promote competition by promoting regulatory parity. We support a concept of functional regulation that would enhance, not impair, the ability of banks to serve their retail customers with maximum efficiency and convenience. We are concerned that the fragmentation of financial services regulation would tend to also fragment the delivery of financial services and thereby interfere with the "seamlessness" with which banks hope to be able to deliver financial services.

For example, a concept of functional regulation that requires banks to transfer customer services out of the bank to another entity and that limits the financial services that a bank can provide directly to its customers would seriously undermine the efficiency with which banks can deliver services. Functional regulation on this basis could balkanize the delivery of financial services and impair the efforts of banks to provide integrated services on a seamless basis.

A recent proposal offered by the National Association of Securities Dealers ("NASD") to regulate bank mutual fund activities is an example of functional regulation that does not necessarily promote competition or regulatory equality.

The CBA strongly supports the concept of a level playing field as a necessary corollary to functional regulation in order to promote competition and enhance the quality of financial products and services for the benefit of consumers and the economy as a whole.

We believe that the purposes of functional regulation can be achieved without requiring banks to transfer their brokerage services out of the bank into a registered broker-dealer, as H.R. 1062 would require. The federal bank regulators have issued an Interagency Statement on Retail Sales of Nondeposit Investment Products which governs the physical location of sales activities, supervision and training of employees, the role of nondeposit employees, compensation, disclosures, confidential customer information, and other issues. In order to help the industry, CBA and other trade associations have worked with the regulators and provided additional clarification in the form of industry guidelines.

The agencies also have adopted detailed examination procedures for supervising bank compliance with the Interagency Statement. The Interagency Statement reflects the agencies' close supervision of retail sales of nondeposit investment products on bank premises through on-site examinations of each bank and other ongoing supervisory measures.

Mr. Chairman, we would encourage the Committee to consider alternative models of functional regulation that would not restrict the ability of banks to best meet the convenience and needs of their customers. We believe that the purposes of functional regulation should be two-fold: first, to ensure that the purposes of a regulation are fulfilled by applying the same regulatory requirements to the same business functions or activities regardless of which type of entity performs those functions or activities; and second, to

ensure that different providers of the same functions or activities are subject to the same regulatory requirements to avoid unfair competition.

Of course, absolute uniformity of regulatory treatment may not always be possible or necessary. For example, some differences in regulatory emphasis may be necessary in order to accommodate differences in the overall regulatory schemes that apply to different types of entities or differing concerns for customers in given circumstances.

Congress Should Establish Principles

The CBA believes that Congress should establish general parameters and principles to guide the regulation of the financial services industry and should allow the banking regulators to fashion reasonable regulatory details through the established administrative process and procedures for rulemaking.

As we have seen clearly over the past two decades, the financial services industry is constantly evolving in response to changes in domestic and international markets due to advances in technology, global economic conditions, customer demands, demographic changes, and other factors. Fixed statutory restrictions and limitations can only frustrate the industry's ability to respond to these changes. The administrative rulemaking process provides an appropriate mechanism by which the industry can adjust to the ever-changing market environment in an appropriate manner consistent with the overriding safety and soundness principles established by Congress.

By delegating to the relevant government agencies the responsibility for ensuring that the industry operates in accordance with clear regulatory principles and objectives established by Congress, Congress can best ensure that those principles will be followed while affording flexibility for the agencies to adjust the regulations when necessary to allow the industry to respond to market changes.

Accordingly, we would ask that the Committee not impose specific restrictions on banks and their affiliates but rather focus its efforts on devising clear regulatory principles and guidelines that the regulatory agencies can implement through the appropriate regulatory process.

An example of where flexibility in the hands of the regulators might be appropriate is in section 120 of H.R. 1062 which sets forth detailed restrictions on contractual arrangements between banks and broker-dealers. The Interagency Statement and agency examination guidelines already address these types of arrangemencs. The agencies have demonstrated that they are able to craft reasonable regulatory provisions to ensure that such contractual arrangements are consistent with statutory purposes. Since the agencies will be responsible for enforcing compliance with the law, it may be appropriate to give them the regulatory discretion to draft regulations that will best facilitate their compliance efforts.

Each Banking Organization Should
Be Able to Structure Its Activities
To Best Serve Its Customers

The different financial regulatory reform proposals that have emerged this year raise important questions concerning the ultimate structure of our banking and financial services system. The questions of which entities should perform which functions and which federal agencies should regulate which entities or functions pose difficult issues of jurisdiction. The CBA does not purport to have the answers to these questions.

But we think we know what the goal should be. We believe that the ultimate goal should be a system that facilitates the most efficient, convenient, and competitive delivery of financial services with a minimum of regulatory restrictions and burdens, consistent with safe and sound banking practices.

In order to achieve this goal, we believe that any legislative solution must afford each banking organization the freedom and flexibility to structure its activities and operations in the way that best serves each bank's customers, and that makes the most sense in light of its own customer base, market profile, business plan, operational capabilities, physical location, and strategic objectives, consistent with safety and soundness considerations.

For some banks, this might mean selling securities and insurance products directly in the bank. For other banks, it might mean using a separate subsidiary of the bank to provide such services. For

still other banks, it might mean conducting these activities in a bank holding company affiliate. Each bank should be allowed to determine which structure is best suited to its ability to deliver financial services to its customers in the most efficient, convenient, and competitive manner.

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Mr. Chairman and members of the Committee, the CBA appreciated this opportunity to present its views on the need for financial services reform and the provisions of H.R. 1062.

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S HOUSE OF REPRESENTATIVES

HEARINGS ON H.R. 1062
THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"

MARCH 7, 1995

TESTIMONY OF

MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

SECURITIES INDUSTRY ASSOCIATION

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STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION
REGARDING H.R. 1062
THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"

HEARINGS BEFORE THE
HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES
MARCH 7, 1995

I. Introduction

Mr. Chairman and members of the Committee, I am Marc E. Lackritz, President of the Securities Industry Association ("SIA"),[1] and I appreciate the opportunity to present SIA's views on H.R. 1062, the "Financial Services Competitiveness Act of 1995." Mr. Chairman, SIA commends you for making financial restructuring a priority for this Committee, and we appreciate your efforts to move the process forward. These hearings, and the introduction of H.R. 1062, attest to your willingness to fashion meaningful financial restructuring legislation. While we believe H.R. 1062 represents a thoughtful and comprehensive approach to modernizing the financial services marketplace, we have some serious concerns that the bill does not fully or fairly balance the competing needs and objectives of securities firms, commercial banks, and consumers of financial services.

II. SIA Supports Comprehensive Financial Services Restructuring

SIA strongly supports Congressional efforts to enact comprehensive financial services reform legislation to best serve American consumers of financial services, and to make it possible for *all* financial services intermediaries to operate more flexibly and

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1 The Securities Industry Association is the securities industry's trade association representing the business interests of about 800 securities firms in North America, which collectively account for about 90 percent of securities firm revenue in the United States. SIA member firms are active in all phases of corporate and public finance, serving individual and institutional investors, corporations, and government entities.

competitively, both domestically and internationally. Modernization of the financial services regulatory structure is critical to maintaining the preeminence of our capital markets and to meeting the serious competitive challenges from abroad.

SIA's position on the issue of bank entry into the securities business has evolved over time for two reasons: 1) federal bank regulators and the courts have rewritten the Glass-Steagall Act through strained regulatory interpretations to permit banks to engage in securities activities, resulting in a very different financial services marketplace today than was contemplated when the Glass-Steagall Act was written; 2) many securities firms wish to take advantage of opportunities in banking that are foreclosed to them by the Glass-Steagall Act's prohibitions.

The regulatory assault on the Glass-Steagall Act that has occurred over the past decade or so has created a balkanized regulatory structure that allows exceptions to the rule to become the norm. When Congress enacted the Glass-Steagall Act in 1933, it established a secure wall between commercial and investment banking activities to guard against excess concentration of financial resources and conflicts of interest between banking and securities interests. For approximately 50 years, that dividing wall remained secure, and the Glass-Steagall Act achieved its principal purpose of protecting the deposits of commercial bank customers, and the federal insurance funds standing behind those deposits, from the risks associated with securities activities. A necessary corollary of the Glass-Steagall Act, of course, was that securities firms were prohibited from engaging in commercial banking activities. The Act has worked well, as the U.S. financial services industry has become the world leader — our capital markets are the envy of the world, and our banking system has reached new and higher level levels of profitability in recent years.

However, starting in the early 1980s, the federal banking regulators gradually began chipping away at the Glass-Steagall Act, and started permitting commercial banks to engage in an increasing variety and level of securities activities. Court

challenges to these regulatory decisions often have been unsuccessful, in large part because courts typically have deferred to the federal banking regulators regarding their interpretations of the Glass-Steagall Act.

For example, in 1982, the Office of the Comptroller of the Currency (the "OCC"), which regulates national banks, ruled that national banks could offer discount brokerage services through subsidiaries.[2] Since then, the OCC has authorized subsidiaries of national banks to engage in a broad range of additional securities activities, including investment advisory and other securities activities, and has shown every indication that it intends to continue to increase bank securities powers through regulatory interpretation.[3] Notably, the OCC typically has authorized these activities via interpretive letter, generally without providing the public with notice or opportunity for a hearing and comment.

Moreover, the Federal Reserve Board of Governors' (the "Board") interpretations of Section 20 of the Glass-Steagall Act have allowed such Section 20 affiliates of commercial banks to derive up to 10 percent of their revenues from underwriting of corporate equity, corporate debt, commercial paper, mortgage-backed securities, and

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2 See In re Security Pacific National Bank, [1982-1983 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,284, at 86,255. The OCC's ruling was upheld by the courts. See SIA v. Comptroller of the Currency, 577 F. Supp. 252 (D.D.C. 1983), aff'd 758 F.2d 739 (D.C. Cir. 1985), cert. denied, 474 U.S. 1054 (1986), aff'd in part and rev'd in part on other grounds sub nom. Clarke v. SIA, 479 U.S. 388 (1987).

3 In November of 1994, the OCC proposed revisions to their "procedural" rules which, if adopted, would permit the OCC to authorize operating subsidiaries of national banks to engage in activities in which even the parent bank could not engage. See Rules, Policies, and Procedures for Corporate Activities, 59 Fed. Reg. 61034 (Nov. 29, 1994). Neither the proposed rule revisions, nor the release accompanying them, even refer to the possibility that this could permit the OCC to authorize operating subsidiaries of national banks to engage in securities underwriting and dealing activities. Accordingly, the OCC made no effort in that release to discuss the myriad of legal issues arising under the Glass-Steagall Act — as well as under other Federal banking laws — that would be involved if the OCC were to permit an operating subsidiary of a national bank to engage in securities underwriting and dealing activities. Moreover, under the OCC's proposed rule revisions, the OCC in theory could authorize an operating subsidiary of a national bank to engage in securities underwriting and dealing activities without even providing the public with notice and an opportunity for a hearing and comment.

municipal revenue bonds.[4] The Board likely will continue to increase the limit in the absence of Congressional action.[5] In addition, under its Regulation Y, the Board permits Section 20 subsidiaries to engage in a wide array of additional securities activities.[6]

Moreover, the Federal Deposit Insurance Corporation, which regulates state-chartered non-Federal Reserve System member banks, has adopted rules to permit such state-chartered banks to engage in securities underwriting and dealing activities directly through bona fide subsidiaries.[7] The FDIC also has permitted state-chartered non-member banks to engage in a variety of additional securities activities.

As a result of these continuing regulatory actions, the Glass-Steagall Act in reality no longer protects bank deposits, or the federal insurance funds, from the risks associated with securities activities. In short, the Glass-Steagall Act's separation between commercial and investment banking has become a Maginot Line, circumvented by regulatory fiat. Federal banking regulators have, in essence, created a one-way street for commercial banking organizations to engage in a wide array of

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4 See Citicorp, 73 Fed. Res. Bull. 473 (1987), aff'd SIA v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir.), cert. denied, 486 U.S. 1059 (1988).

5 In July of 1994, the Board proposed to permit Section 20 subsidiaries to derive up to 10 percent of their income from underwriting and dealing activities, or to devote up to 10% of their assets to such activities. See 10 Percent Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 59 Fed. Reg. 35516 (July 12, 1994). The release accompanying these proposals couched them merely as efforts to prevent interest rate movements from affecting the amount of securities underwriting and dealing activities in which Section 20 subsidiaries may engage under the current "10 percent revenue" test. However, the release failed to mention that these changes also could significantly increase the amount of securities underwriting and dealing activities in which Section 20 subsidiaries may engage. Additional Board materials requested by SIA contain no documents suggesting that the Board had attempted to quantify the level of securities underwriting and dealing activities in which Section 20 subsidiaries could engage under the proposals. Interestingly, shortly before issuing the proposals the Board had received a letter from a number of Section 20 subsidiaries and their affiliates requesting the Board to increase the amount of securities underwriting and dealing activities in which Section 20 subsidiaries could engage, from 10 percent of revenues to 25 percent of revenues.

6 See 12 C.F.R. § 225.25.

7 See 12 C.F.R. § 337.4. These regulations were upheld in Investment Company Institute v. Federal Deposit Insurance Corporation, 815 F.2d 1540 (D.C. Cir.), cert. denied. 484 U.S. 847 (1987).

securities activities while securities firms remain stalled at the entrance ramp to banking. SIA therefore believes Congress — not banking regulators or the courts — should undertake a comprehensive restructuring of the regulation of financial services to benefit all providers of financial services, and ultimately, the American public.

As the trade association for a diverse, competitive and often times fractious industry, SIA is acutely aware that no single legislative approach can completely satisfy the concerns of all securities firms, just as no single legislative approach can completely satisfy the concerns of all commercial banks. However, SIA and its members have worked diligently and constructively to transcend the varying and at times seemingly incompatible positions of its members regarding financial services restructuring. For example, in 1991, SIA released a financial services restructuring proposal that sought to balance the competing needs and objectives of commercial banks and securities firms alike. Under SIA's plan, commercial banks would have been permitted to engage in securities activities through affiliates, and securities firms would have been permitted to directly own uninsured, wholesale banks. Since that time, SIA has continued to work with its member firms to further develop a consensus as to the key elements that any financial services restructuring legislation should contain.

SIA is heartened that both commercial banks and federal bank regulatory agencies now appear to support financial services restructuring legislation, although it is not clear that the commercial bank industry, or the different bank regulators, have as yet reached consensus on the key elements of such reform. We also are pleased with the introduction of other legislation in the House and Senate, as well as the prospect of a financial modernization proposal from the Administration.

As a result, SIA believes that there now may exist a unique opportunity to pass comprehensive financial restructuring legislation that will fundamentally improve the way financial services are provided in the United States. We also believe that legislation can be crafted that will satisfy the principal concerns of the commercial

banks and securities firms most affected by the current Glass-Steagall Act restrictions and, more importantly, will best meet the needs of the American consumer of financial services.

III. SIA's Three Principles For Comprehensive Financial Services Restructuring

In the debate over financial modernization, it is easy to get caught up in arguing over which sector is helped, or harmed, the most. While fair competition among all financial services providers should certainly be an objective of any financial services legislation, the overriding concern must be whether any such proposal truly benefits the public. That is why SIA believes that if commercial banking organizations are to be granted expanded authority to compete in the securities business, they must do so without federal subsidies, with safeguards to enhance the safety and soundness of the federal deposit insurance system, and with a balanced appreciation for the competitive integrity of the capital markets. To achieve those objectives, and to gain widespread support, any comprehensive financial services restructuring legislation should at a minimum be consistent with the following three principles:

> 1. ***Competition Without Federal Subsidies***. Securities activities should be performed in separately capitalized affiliates of banks, and those affiliates should have no access to the deposits or credit power of a federally insured bank.
>
> 2. ***Two-Way Street***. Banking firms should have the ability to own full service securities firms. However, full service securities firms also should have the ability to own banks and bank holding companies.
>
> 3. ***Functional Regulation***. This is an integral component of any financial restructuring legislative proposal because it protects investors and eliminates unfair competitive advantages. One federal regulatory agency should apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of financial institution it may be.

These principles are intended to protect the taxpayer, keep the U.S. capital markets open, competitive and free, and yet make it possible for all sectors of the financial services industry to operate more flexibly.

IV. Discussion of the Financial Services Competitiveness Act of 1995

H.R. 1062, the Financial Services Competitiveness Act of 1995 (the "Act") contains provisions that achieve a portion of each of SIA's three principles for comprehensive financial restructuring. We believe, however, some of the Act's provisions are inconsistent with these principles and with sound public policy.

Competition Without Federal Subsidies. The Act generally prohibits an insured depository institution that is affiliated with a securities firm from engaging in securities underwriting, dealing, mutual fund and certain other securities activities. Instead, any such activities must be performed in a separate "Section 10 Affiliate." The Act also imposes various "firewalls" between the activities of an insured depository institution and a Section 10 Affiliate.

In addition, the Act authorizes a new type of bank holding company called an "investment bank holding company" (an "IBHC"). All depository institutions held by an IBHC must be uninsured state-chartered banks. Accordingly, an IBHC or its affiliates that engaged in securities activities would have no access to deposits or the credit power of a federally insured bank. SIA strongly supports the non-federally insured bank approach because it provides the necessary synergies without putting federally insured deposits at risk or allowing federal deposit insurance to create an unfair competitive advantage over firms which cannot be (or choose not to be) affiliated with a federally insured commercial bank.[8]

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8 SIA's 1991 Financial Restructuring and Taxpayer Protection proposal would have created a non-federally insured national bank, called an "Investment Banking Financing Company" ("IBFC"), to support

Nonetheless, under the Act, insured depository institutions could engage directly in certain securities activities, and thus effectively could support those activities through its insured deposits. For example, the Act would permit an insured depository institution to engage in securities brokerage and investment advisory activities, and to underwrite and deal in bank-eligible securities. Significantly, municipal revenue bonds would be deemed to be bank-eligible securities for well-capitalized institutions, subject to certain geographic limitations, and thus certain insured depository institutions could underwrite and deal in municipal revenue bonds. Also, an insured depository institution that is not affiliated with a Section 10 Affiliate would be permitted to privately place securities to accredited investors.

SIA believes that such securities activities — particularly municipal bond underwriting and dealing activities, and private placements to accredited investors — should be performed only by a separately capitalized affiliate of an insured depository institution. It is inconsistent with the objectives of the Act, and with sound public policy, to subject insured deposits to the risks associated with these activities, especially since these activities typically do nothing to advantage the customers whose deposits are maintained at the bank, and do not in any way advantage the bank insurance fund.

In addition, we believe that the firewalls imposed by the Act are insufficient to prevent potential credit abuses by a bank affiliated with a securities firm. SIA has argued consistently that Congress must provide clear, bright line firewalls on the issue of permissible transactions between affiliates. Providing significant exceptions to each firewall, or allowing the Federal Reserve Board to modify them, as the Act does, reduces the effectiveness of the firewalls and allows regulators to substitute their judgment for Congress's. We believe the firewalls should not be subject to significant

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and service the domestic and international securities and securities-related activities of affiliates within the bank holding company structure.

exceptions and that the Board's authority should be limited to interpretation, not elimination, or even modification, of statutorily imposed firewalls.

Also, SIA consistently has supported the concept of permitting securities firms and others to own uninsured state-chartered banks, and, as noted above, the Act generally would permit such affiliations by IBHCs. However, we believe that there is no reason to extend the affiliate transaction restrictions of Sections 23A and 23B of the Federal Reserve Act to an uninsured state-chartered bank owned by an IBHC. Such banks do not accept insured deposits, and so there is no more justification for applying the affiliate transaction restrictions to those banks than there is for applying the affiliate transaction restrictions to any other uninsured financial institution.

In addition, the Act generally would prevent a company from becoming an IBHC — i.e., from acquiring an uninsured state-chartered bank — if more than 10 percent of its total consolidated capital and surplus are invested in shares of companies engaged in certain activities, such as insurance underwriting activities, or in activities that the Board has not determined to be "financial in nature." As a result, an IBHC could not, for example, own shares of a subsidiary engaged in insurance underwriting activities if those activities exceed 10 percent of the total consolidated capital and surplus of the IBHC. These restrictions appear to be arbitrary, and should be deleted. In this regard, securities and other firms commonly engage in insurance underwriting activities, and in various other activities that the Board might deem not to be financial in nature. There is no apparent reason why these firms should be required to choose between continuing these activities, or acquiring an uninsured state-chartered bank.

Two-Way Street. The Act permits a bank holding company to own a full service securities subsidiary (a Section 10 Affiliate). The Act also specifically provides that certain securities firms may own insured banks. However, the Act provides a number of limitations on the ability of a securities firm to own an insured bank, and we believe that these limitations should be removed.

For example, a securities firm could acquire an insured bank only if more than 50 percent of the business of the securities firm for each of the past two years involved certain securities activities. This provision effectively could prevent a number of "full service" securities firms from acquiring insured depository institutions, because at least 50 percent of the business of such firms often involves activities other than the prescribed securities activities, such as insurance and merchant banking activities. Also, it is not entirely clear how to measure whether "more than 50 percent of the business" of a particular securities firm involves securities activities. Is such a determination to be made by reference to revenues, profit, assets allocated to a particular business, or some other measure?

In addition, a securities firm generally could continue to engage in non-securities activities only if: (1) the Board has authorized such "financial activities;" (2) the securities firm engaged in such activities through a subsidiary; (3) the securities firm acquired the shares of that subsidiary at least two years prior to acquiring the bank; and (4) the securities firm's investment in those shares (as well as the shares of subsidiaries engaging in other activities not now permissible for a bank holding company) did not exceed 10 percent of the total consolidated capital and surplus of the securities firm.

These provisions, too, effectively would prevent securities firms from acquiring insured banks if the securities firm engaged in significant levels of insurance, merchant banking and other non-securities activities. We believe that securities firms should be allowed to affiliate with commercial banks without requiring the securities firm to change substantially its operations. Also, these provisions would have the effect of forcing securities firms to choose between continuing to engage in non-financial activities or engaging in bank activities. Specifically, the Act would require a securities firm to divest the shares of any companies engaged in non-financial activities (as determined by the Board), generally within 5 years, and in any event by 10 years. Currently, it is common for securities firms, through their merchant banking and other operations, to engage in

activities that might not be deemed to be financial activities. We believe a more competitive and fair approach is to permit securities firms to continue engaging in non-financial activities, without restriction, and to impose firewalls to prevent inappropriate lending and similar arrangements with affiliated banks.[9]

There is also some ambiguity as to what activities the Board should deem to be financial activities and how firms should calculate "total consolidated capital and surplus."[10] These provisions raise additional concerns about joint marketing and corporate structure.[11]

Functional Regulation. SIA believes that securities activities by any entity, be it a broker-dealer or a bank, raise concerns as to the adequate protection of investors and the operation of fair and efficient securities markets. The discrepancies between the regulatory treatment of banks and broker-dealers become more pronounced and of greater concern as bank securities services become widely and aggressively promoted

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9 The Act also would require a securities firm to engage only in those non-financial activities in which it engaged as of the date it acquired a bank. The effect of these provisions could be to prevent a securities firm from pursuing legitimate business opportunities necessary to remain competitive. Again, we believe that a more competitive and fair approach is to permit securities firms to continue engaging in non-financial activities, without restriction, subject to appropriate firewalls.

10 Certain significant terms used in this part of the Act (and elsewhere, such as in connection with IBHCs) are largely undefined. For example, the Act does not provide significant guidance as to what activities the Board should deem to be financial activities. The Act also does not specify how a firm engaging in, for example, diverse activities — such as insurance, real estate, securities and banking activities — is to calculate its "total consolidated capital and surplus." In this regard, firms engaging in these different activities typically calculate capital, surplus and similar financial measures in substantially different ways (and in some instances, not at all).

11 The Act would prevent a bank owned by a securities firm from jointly marketing any product or service of any affiliate. We believe that this restriction is not necessary. In this regard, no comparable restriction is imposed with respect to joint marketing between an insured depository institution and a Section 10 Affiliate, and it is not clear why such a restriction should apply to a bank owned by a securities firm. Also, the Act appears to require all non-securities activities to be conducted in one or more subsidiaries of the securities firm. For example, if a securities firm engaged in non-securities activities at the parent company level, the Act apparently would require the securities firm to restructure its operations so that those activities were performed by a subsidiary. Moreover, the Act could be read to require those activities to be performed by a subsidiary for at least two years prior to the time the securities firm acquired an insured bank. We are aware of no valid reason that a securities firm should be required to change its corporate structure in such a way in order to acquire an insured bank.

and used by the public (witness the recent customer confusion between federally insured bank deposits and uninsured mutual fund investments sold through banks). While the Act generally would provide for functional regulation,[12] there are notable exceptions. For example, a bank could continue to act as a broker, dealer or underwriter of certain bank-eligible securities, without being required to register with the SEC as a broker-dealer. Similarly, a bank that was not affiliated with a Section 10 Affiliate could engage in private placements to accredited investors, without being required to register with the SEC as a broker-dealer. And, in addition to providing other exemptions for banks from the SEC's broker-dealer registration requirements, the Act also would permit a bank to engage in as many as 1,000 brokerage transactions each year without registering as a broker-dealer.

In addition, SIA believes the Act creates an unnecessarily complicated regulatory structure. We believe the role of the federal banking agencies should be clearly defined. The Federal Reserve Board or the appropriate federal banking agency should be responsible for regulating the insured banks in a holding company. The Board's oversight responsibility for a holding company that contains banking and other financial services should be to: 1) enforce any restrictions on transactions between the insured bank and the other affiliates within the holding company; and 2) ensure that there is sufficient capital in the holding company to provide that it serves as a source of strength for the insured bank.

The registered broker dealer should continue to be regulated by the SEC or the appropriate securities regulator (such as the Commodity Futures Trading Commission). The activity of the registered broker dealers should not be regulated by the federal banking regulators. Other activities such as insurance, merchant banking, or

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12 A Section 10 Affiliate would be regulated by the Securities and Exchange Commission (the "SEC"), while its affiliated insured depository institution would be regulated by the appropriate Federal banking agency.

commercial activities, which are not now regulated by federal banking regulators, should be regulated in the manner they are today.

V. Conclusion

We commend Chairman Leach and this Committee for your efforts to comprehensively reform the financial services industry, and we support those efforts. It is long past time to revamp a regulatory structure that, while helping to make the nation's commercial and investment banking systems into national assets, has been rendered obsolete by deregulation, immense business changes, and technological advances. The legal separation between commercial and investment banking no longer reflects the realities of today's very different financial marketplace. That barrier in turn increases costs to customers and decreases the efficiency of the financial services industry.

To be sure, differences between the commercial and investment banking businesses continue to warrant differences in regulation, and unfettered combinations between commercial and investment banks still may give rise to various concerns, including the undue concentration of financial power in a single entity. However, in today's financial world, the Glass-Steagall Act's separation of commercial and investment banking is an unnecessarily blunt anachronism with which to regulate these legitimate concerns. The Glass-Steagall Act is the legal equivalent of a sledge hammer, when a scalpel is required. SIA looks foward to assisting the Chairman, the members of the Committee and their staffs, with crafting a bill that truly reforms the regulation of financial services to provide competition without federal subsidies, a two-way street for entrance into banking and securities activities, and functional regulation. Such a bill would provide for equal competitive opportunities for all financial services providers which would ultimately benefit the taxpayers and consumers of financial services.

STATEMENT OF MATTHEW P. FINK

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"

H.R. 1062

MARCH 7, 1995

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I. INTRODUCTION/SUMMARY

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 5,510 open-end investment companies ("mutual funds"), 471 closed-end investment companies, and 12 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $2 trillion, accounting for approximately 95 percent of total industry assets, and serve over 38 million individual shareholders. The Institute's members include mutual funds advised by investment counseling firms, broker-dealers, insurance companies, and commercial firms. The Institute's members also include approximately 1200 mutual funds advised by banks, accounting for almost 90 percent of all mutual funds advised by banks.

I am pleased to be here today to testify on H.R. 1062, the "Financial Services Competitiveness Act of 1995," introduced by Chairman Leach. This bill would repeal the Glass-Steagall Act's restrictions on banks securities activities and address inefficiencies in the regulatory oversight of bank securities activities. In addition, the bill would amend the Investment Company Act to establish investor protections tailored for banks that advise mutual funds. These provisions would parallel the investor protections already contained in the Investment Company Act with respect to securities firms that advise mutual funds. The bill also would modernize the federal securities laws by repealing the exemptions for banks from regulation as investment advisers and broker-dealers. The Institute broadly supports these provisions of H.R. 1062.

The Institute, however, has strong reservations about the extent of Federal Reserve Board oversight of non-bank activities under the bill. Secondly, the Institute supports amending the Bank Holding Company Act to establish a "two-way street" for securities firms that wish to engage in commercial banking. The absence of such amendments to the Bank Holding Company Act is something that we hope will be remedied so that a successful legislative outcome can be achieved. In our view, such amendments would simply establish competitive equality between securities firms and banks.

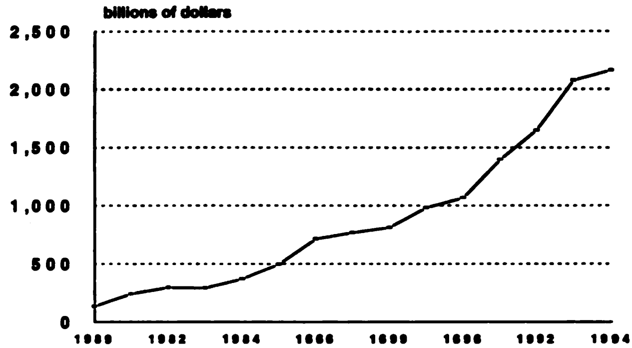
II. BACKGROUND

A. Growth and Regulation of the Mutual Fund Industry

Since 1940, when Congress enacted the Investment Company Act, the mutual fund industry has grown steadily from 68 funds in 1940 to over 5,000 funds today, and from assets of $448 million in 1940 to over $2 trillion today. Mutual fund assets now are only slightly below commercial bank deposits.

Figure 1

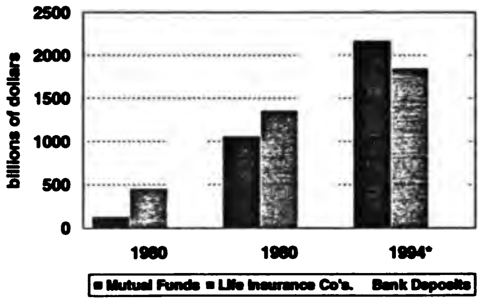
Mutual Fund Assets, 1980 - 1994



Source: Investment Company Institute.

Figure 2

Bank Deposits and Assets of Mutual Funds and Life Insurance Companies

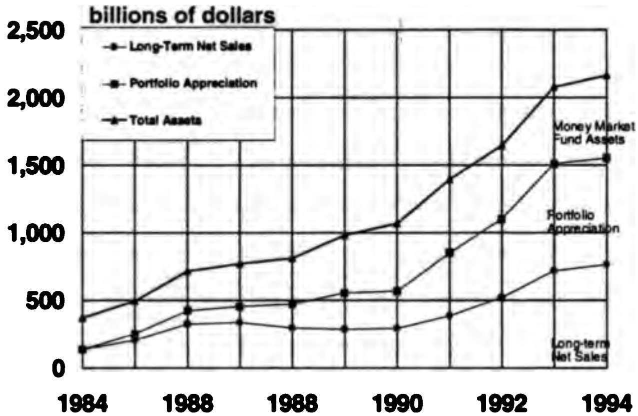


* Third quarter.
Source: Investment Company Institute and Federal Reserve Board.

Many factors have contributed to the growth of the mutual fund industry over the years. They include the capital appreciation of portfolio securities, additional purchases by existing fund shareholders, new products and services designed to meet changing investor needs, the growth of the retirement plan market, increased investment by institutional investors, new distribution channels, and a shift by individuals and institutions from direct investment in securities to investment through mutual funds.

Figure 3

Components of Mutual Fund Asset Growth



Source: Investment Company Institute

In our view, the most important factor contributing to growth, however, is that mutual funds are subject to stringent regulation under the Investment Company Act. This regulatory scheme imposes a strict discipline on mutual funds to which other pooled investment vehicles generally are not subject and provides an important source of investor confidence in the integrity of the mutual fund industry.

Unlike the other federal securities laws, which are designed to protect investors primarily through *disclosure*, the Investment Company Act imposes a series of detailed, *substantive* requirements and restrictions on the structure and day-to-day operations of mutual funds. The core objectives of the Act are to: (1) ensure that investors receive adequate, accurate information about the mutual fund; (2) protect the physical integrity of the fund's assets; (3) prohibit or regulate forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) ensure the fair valuation of investor purchases and redemptions.

B. Bank Participation in the Mutual Fund Industry

Banks and their affiliates are currently permitted to engage in a wide range of mutual fund-related activities. These activities include: (1) serving as a fund's investment adviser; (2) providing discount and full-service brokerage services with respect to sales of mutual fund shares; (3) providing administrative services to a fund; and (4) serving as a fund's transfer agent and custodian. The Glass-Steagall Act, however, prohibits banks from sponsoring, or underwriting or distributing the shares of, a mutual fund.[1] In addition, the Glass-Steagall Act, as interpreted by the Federal Reserve Board, bars officers, directors, and employees of any member bank from serving as a director, officer, or employee of a mutual fund.[2]

Despite these limits, the participation of banks and their affiliates in the mutual fund industry has increased substantially in recent years. For example, six years ago bank mutual fund sales were limited primarily to sales of nonproprietary funds (i.e., funds advised by an

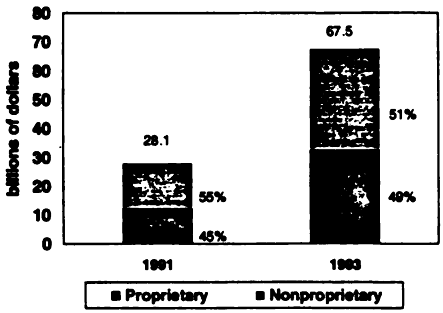
[1] Sections 16 and 21 of the Glass-Steagall Act prohibit banks from sponsoring, or underwriting or distributing the shares of, mutual funds. Section 20 of the Act prohibits national banks and state banks that are members of the Federal Reserve System from affiliating with companies engaged in sponsoring, or underwriting or distributing the shares of, mutual funds.

[2] The Board has interpreted Section 32 of the Glass-Steagall Act to prohibit these interlocks.

entity unrelated to the bank). While sales of nonproprietary funds still account for the majority of bank mutual fund sales, today over 119 banks offer proprietary mutual funds (i.e., funds advised by the bank), with approximately $300 billion of assets under management.

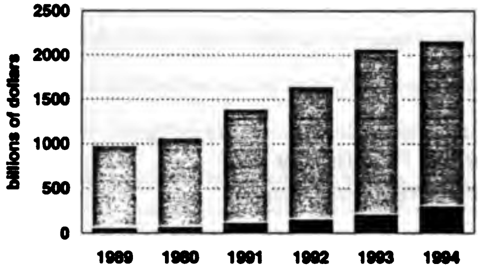
Figure 4

Bank New Sales of Proprietary and Nonproprietary Long-term Funds



Source: Investment Company Institute.

Figure 5
Assets of Proprietary Bank Mutual Funds and All Mutual Funds



Source: Investment Company Institute and Lipper Analytical Services, Inc.

Bank entry into the mutual fund business has proven to be a positive development for the banking industry, the mutual fund industry and the investing public. At the same time, however, the growth of bank participation in the mutual fund business -- which has taken place in the absence of authorizing legislation -- requires that several outstanding matters be addressed by Congress. These include the need to (1) remove unnecessary legal barriers to bank mutual fund activities; (2) clarify the responsibilities of the various regulators, so that duplicative regulation and gaps in regulation are avoided; (3) where appropriate, modernize the Investment Company Act to add investor protection provisions tailored for banks that advise or sponsor mutual funds (parallel investor protection provisions designed for securities firms that advise or sponsor mutual funds are already contained in the Investment Company Act); and (4) repeal outmoded exemptions for banks under the federal securities laws, which were enacted at a time when bank securities activities were far more limited. While H.R. 1062 largely answers many of these concerns, it does not address the important additional need to

establish a "two-way street" for securities firms wishing to engage in commercial banking. Nor does it rationalize the role of the Federal Reserve Board vis-à-vis the nonbanking activities of such firms. In our view, amendment of the Bank Holding Company Act for such purposes is essential.

III. EXPANSION OF BANK MUTUAL FUND POWERS

As part of a broader bill that would accomplish the purposes set forth above, the Institute supports the expansion of banks' mutual fund powers. The federal courts and the federal banking agencies have allowed banks to engage in most mutual fund-related activities, and the remaining restrictions under the Glass-Steagall Act are increasingly perceived as "statutory vestiges" that serve no useful purpose in today's financial markets.

In particular, the Institute strongly supports H.R. 1062's amendment to Section 20 of the Glass-Steagall Act that would enable bank affiliates to sponsor, and underwrite and distribute the shares of, mutual funds. The Institute also strongly supports the bill's amendment to Section 32 of the Glass-Steagall Act that would permit an officer, director, or employee of a member bank to serve simultaneously as an officer, director, or employee of a bank securities affiliate. The Institute notes, however, that the bill, as drafted, would leave intact the current restriction on interlocking directorates between a fund and its affiliated bank.[3] The Institute believes that the bill should be amended to remove this restriction.

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[3] Section 101(b) of the bill would amend Section 32 of the Glass-Steagall Act to permit an officer, director, or employee of a member bank to serve simultaneously as a director, officer, or employee of the *securities affiliate*. Since the bill's definition of "securities affiliate" does not include a mutual fund, however, it appears that Section 32, as interpreted by the Federal Reserve Board, would continue to bar officers, directors, or employees of any member bank from serving as an officer, director, or employee of a mutual fund.

The Board has also interpreted the ban on interlocking directorates to apply to interlocks between a member bank and a corporation that provides investment advisory and related services to mutual funds in certain circumstances, including those in which the corporation was "created for the sole purpose of serving a particular fund, and its activities were limited to that function." 12 CFR 218.107. The Institute supports amending the bill to remove this bar.

IV. REGULATION OF BANK MUTUAL FUND ACTIVITIES

A. Current Regulatory Environment and the Need for Functional Regulation

Exemptions for banks under current law, which are discussed more fully below, have prompted the federal banking agencies to establish their own competing regimes for regulation of bank mutual fund activities. Inevitably, this has created regulatory inconsistencies and duplication of effort and placed unique regulatory burdens on banks engaged in the mutual fund business.

H.R. 1062 properly addresses the oversight roles that the SEC and the federal banking regulators should have over bank mutual fund activities by making clear that the federal banking agencies should generally defer to the SEC on matters regarding bank mutual fund activities. For several reasons, the Institute strongly supports this "functional" approach to regulation of bank mutual fund activities. First, it is an efficient and responsible use of taxpayer dollars and government resources. There is no justification for creating and training "mini-SECs" to do the job that Congress created the SEC to do and which the SEC has been doing for over 50 years. Second, functional regulation provides the greatest assurance of the continuing safety and soundness of banks engaged in the mutual fund business. If bank-sold or bank-advised funds are fully subject to regulation under the federal securities laws, there is a greater likelihood that banks will conduct their mutual fund activities subject to appropriate controls and thus avoid potential liabilities or losses. Third, having one expert securities regulator will minimize the regulatory costs on banks and increase the likelihood of banks succeeding in the mutual fund business. Finally, and not least importantly, a single set of regulations uniformly applied will lead to better and more consistent protection for mutual

fund investors. Accordingly, the Institute supports the provisions of H.R. 1062 that are intended to clarify the responsibilities of bank and securities regulators, subject to certain modifications noted below.

B. Information Sharing Among the SEC and the Federal Banking Agencies

Section 140 of the bill would require the appropriate federal banking agency to share with the SEC the results of any examination, reports, records, or other information with respect to the investment advisory activities of any bank or separately identifiable department of a bank to the extent necessary for the SEC to carry out its statutory responsibilities. Similarly, the SEC would be required to provide all such information to the appropriate federal banking agency. The Institute supports this provision, which provides a practical response to a situation where more than one regulator has jurisdiction over the same entity, and each regulates a different aspect of that entity's business. An information sharing provision like the one in the bill should assist regulators in assuring that wrongdoing and questionable practices are detected.[4] This, in turn, should lead to greater investor protection.

In addition, Section 103(f)(13)(A) of the bill would require the SEC and the federal banking agencies to establish a program for sharing information concerning compliance with the bill. Section 103(f)(13)(F) of the bill would require the SEC to notify the federal banking agencies, and the federal banking agencies to notify the SEC, when an order of investigation is entered or an enforcement proceeding is initiated against a broker-dealer or adviser that is affiliated with a bank. Section 103(f)(13)(G) of the bill would require the SEC and the federal

[4] The Institute suggests modifying the bill to require the SEC and the federal banking agencies to share records that each "have access to" rather than merely records the agencies "have" since, as a practical matter, the requisite agency might not have in its possession the records sought by the requesting agency.

banking agencies to coordinate, to the extent practicable, enforcement actions where the actions are based on the same or related events. The Institute supports such coordination between the SEC and the federal banking agencies and is hopeful that it will lead to more comprehensive and consistent oversight of banks engaged in the mutual fund business.

C. Examination Authority

Section 103(f)(13)(H) of the bill explicitly provides that the federal banking agencies do not have the authority to examine mutual funds not affiliated with banks. The Institute supports this provision because it believes that any benefit to be derived from the banking agencies examining mutual funds that are not affiliated with banks would be outweighed by the regulatory burden placed on funds and banks.[5] Furthermore, since the SEC already examines mutual funds, it would be an inefficient use of government resources for the banking agencies to duplicate those efforts.

Section 103(f)(13)(D) of the bill would require the banking agencies, to the extent practicable, to use SEC examination reports of advisers, mutual funds, and broker-dealers affiliated with banks and to defer to such examinations for ascertaining compliance with the federal securities laws.

[5] The Institute understands that the OCC has drafted guidelines for its examiners to use in examining virtually all aspects of mutual fund operations when a bank or its affiliate "provides services" to the mutual fund. This appears to encompass mutual funds that are not advised by or otherwise affiliated with a bank.

The Institute previously has expressed its concern over the unique regulatory burdens placed on banks engaged in the mutual fund business and has stated that duplicative examinations by the SEC and the federal banking agencies should be avoided. This provision appears to address this concern.[6]

D. Interpretations of the Federal Securities Laws

Section 103(f)(13)(E) of the bill would require the federal banking agencies to defer to the SEC regarding all interpretations and enforcement of the federal securities laws relating to investment advisers and mutual funds. The Institute strongly supports this provision and notes that it should promote more efficient and streamlined government by requiring one regulator with the most expertise to interpret the federal securities laws.

V. INVESTMENT COMPANY ACT INVESTOR PROTECTION AMENDMENTS

The Investment Company Act contains a number of provisions that address the risk that an investment adviser will enter into transactions that benefit the adviser or a related party to the detriment of the fund's shareholders. While these provisions apply to any entity that advises a mutual fund (including any bank), they are specifically directed toward conflicts that may arise when a particular type of securities firm advises a fund. For example, Section 10(f) of the Act prohibits a mutual fund from purchasing shares during the existence of an

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[6] The Institute suggests deleting the phrase, "to the extent practicable" to more clearly establish the SEC as the functional regulator of the mutual fund activities of banks. Especially in light of the bill's information sharing requirements, the federal banking agencies should not have the need to independently examine mutual funds registered with, regulated by, and subject to examination by the SEC.

underwriting if its investment adviser, or an affiliated person, is a principal underwriter of the offering. Section 17(a) prohibits an adviser to a mutual fund from selling securities or property to the fund while acting as principal. Section 17(e) is directed at brokers that advise mutual funds and limits the commissions that such brokers may accept in connection with a sale of securities to or for an affiliated fund.

The reason these provisions are focused on securities firms, rather than banks, most likely is that at the time they were enacted, it was thought that the Glass-Steagall Act prevented banks and their affiliates from sponsoring or advising funds. Consequently, the Investment Company Act does not currently address parallel conflicts that may arise in situations where a bank or a bank affiliate sponsors or advises a mutual fund.

H.R. 1062 would amend the Investment Company Act by adding these types of investor protection provisions. In general, the Institute supports the bill's provisions, which are especially important given the expanded role of banks in the mutual fund business. We are pleased that, for the most part, these provisions are limited to those necessary to address the core conflicts that can arise between a mutual fund and an affiliated bank, such as a when a bank serves as a custodian for an affiliated fund, when a bank loans money to an affiliated fund, or when a bank causes its affiliated fund to purchase securities, the proceeds of which are used to retire indebtedness owed to an affiliated bank.

Mutual fund shareholders should be assured of protection against these conflicts, just as they now enjoy protection from the analogous conflicts that can arise between a mutual fund and an affiliated securities firm. In addition, it should be noted that current banking laws do not address these conflicts. [7]

Conversely, we believe that legislation should not impose restrictions on banks that go beyond those necessary to address these unique investor protection issues. In general, H.R. 1062 avoids this problem. We would, however, recommend certain changes, such as replacing the bill's prohibitions on certain activities with grants of rulemaking authority to the SEC to regulate such activities. Since banks are now major participants in the mutual fund business, the enactment of new prohibitions could prove to be unnecessarily disruptive.

The Institute would welcome the opportunity to provide the Committee with more specific comments on these provisions in the near future.

[7] For example, while Sections 23A and 23B of the Federal Reserve Act apply to certain transactions between member banks and their affiliates, including affiliated mutual funds, these are intended to protect the bank, not the mutual fund or its shareholders. Thus, for example, a lending arrangement between a bank and an affiliated fund on terms that are at least as favorable to the bank as it could obtain in an arm's length transaction with another borrower would not raise questions under Sections 23A or 23B, even though it could be contrary to the interests of the fund and its shareholders.

Another important provision is Section 141 of the bill, which would clarify that the Investment Company Act's exclusion for common trust funds is only available for common trust funds that are not advertised and are not charged certain additional fees or expenses. This provision is critical to the goals of H.R. 1062 and should be enacted. If common trust funds could be advertised and charged double fees, they would become indistinguishable from mutual funds and, as such, should register with the SEC.

VI. NEED FOR FUNCTIONAL REGULATION OF INVESTMENT ADVISERS AND BROKER-DEALERS

A. Bank Advisory Activities

The Investment Advisers Act of 1940 excludes banks and bank holding companies from registration and regulation as investment advisers (although subsidiaries and affiliates of banks are not exempt).[8] As a result, the SEC can inspect the records of a bank-advised mutual fund, but lacks authority to review other bank records that might be relevant to an examination of the mutual fund's portfolio transactions. In addition, banks, unlike other investment advisers, are not subject to the Investment Advisers Act's restrictions on performance fees, principal transactions and agency-cross transactions. Consequently, purchasers of bank-advised funds do not receive the same protections under the federal securities laws as investors in other mutual funds.

H.R. 1062 wisely eliminates this gap in the federal securities laws by removing the Advisers Act exemption for banks and bank holding companies that advise mutual funds. In addition, the bill would permit a bank to conduct these advisory activities in a separately identifiable department or division of a bank. The Institute believes that banks and bank holding companies that advise mutual funds should be held to the same standards as other investment advisers. The Institute also supports permitting banks to conduct these activities in a separately identifiable department of the bank.

[8] Section 202(a)(11) of the Investment Advisers Act.

B. **Bank Sales Activities**

Most banks conduct their sales of securities through registered broker-dealers that are subject to regulation by the SEC and self-regulatory organizations that are supervised by the SEC. Banks that directly sell securities, however, are exempt from the definitions of broker and dealer under the Securities Exchange Act of 1934.[9] Consequently, such banks are not required to register with or be regulated by the SEC as brokers or dealers. Likewise, by definition, banks are excluded from membership in self-regulatory organizations such as the National Association of Securities Dealers, Inc. ("NASD").[10] Thus, bank employees engaged in sales activities are not required to complete professional licensing requirements applicable to personnel of other broker-dealers, nor are they required to comply with self-regulatory rules.[11] Similarly, bank employees who assume supervisory duties with respect to other employees involved in sales activities need not pass a qualifying examination (unlike other broker-dealer personnel). Moreover, because such persons need not obtain a license to sell securities, they are not subject to losing their license if they engage in improper sales practices, as is the case with other broker-dealer personnel.

H.R. 1062 recognizes the need to functionally regulate banks' retail brokerage activities. It would repeal the exemption from the definition of broker for banks that publicly solicit brokerage business or receive incentive compensation for providing brokerage, and that do not limit their activities as described in the bill. Similarly, H.R. 1062 would amend the definition of

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[9] Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act.

[10] See NASD By-laws, art. I, sections (d), (g).

[11] The four federal banking agencies jointly issued guidelines for banks last year, stating that banks should provide bank employees engaged in sales of securities with training substantively equivalent to that required for personnel of registered broker-dealers. Bank personnel, however, unlike personnel of registered broker-dealers are not required to obtain such training. See Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994).

dealer in the Securities Exchange Act to include banks, except those banks that engage in certain dealing activities described in the bill. The Institute supports these provisions of H.R. 1062.

VII. BARRIERS TO ENTRY TO THE BANKING BUSINESS

As noted above, the one important objective of financial services reform that H.R. 1062 would not achieve is the establishment of competitive equality between banks and securities firms. This is a consequence of the bill's preservation of the strict separation between "banking" and "commerce". Specifically, securities firms would only be able to acquire insured banks by becoming financial services holding companies and divesting their nonfinancial businesses within five years. This approach would introduce clear competitive inequities: all banks could enter the securities business, but many of the nation's securities firms could not own commercial banks. To provide for a fair and balanced competitive environment, the Institute strongly recommends that the Committee amend Section 4 of the Bank Holding Company Act, which currently limits the activities of a bank holding company and its affiliates.

Many of the nation's large securities firms are affiliated with firms engaged in various commercial activities. Consequently, unless the ownership restrictions in Section 4(c)(8) of the Bank Holding Company Act are liberalized, these securities firms will remain unable to enter the business of banking. This would place securities firms at a disadvantage as compared to banks, since all banks would be able to enter the securities business. This competitive disadvantage would apply to a broad range of firms, from those affiliated with a major commercial corporation to those that may own a small affiliate that engages in nonfinancial

activities. (For example, one investment adviser to a mutual fund owns a publishing company and a limousine service. Another owns a gold mine.) Since securities firms have never been subject to the types of restrictions set forth in Section 4(c)(8), there would have been no reason for them to avoid entering such businesses. Yet these types of businesses could become a significant handicap under H.R. 1062.

Many of the nation's largest securities firms also are affiliated with firms engaged in the insurance business, real estate business or other businesses that might be considered to be "financial" in nature. The Institute is pleased that H.R. 1062 has been revised in a manner that would apparently make it easier for certain of those securities firms to enter the banking business. Specifically, the bill appears to permit a securities firm that becomes a financial services holding company to engage in activities that are determined by the Federal Reserve Board to be "financial" activities or other activities incidental thereto. The Institute is very concerned, however, that the analysis accompanying the bill states that "financial" activities would not include insurance activities. Furthermore, the bill would leave the determination of what constitutes "financial" activities to the Federal Reserve Board, rather than Congress. The Institute recommends that the bill make explicit that insurance and real estate activities are "financial" activities for purposes of Section 4(c)(8) of the new Financial Services Holding Company Act. This will assure that securities firms that are engaged in these businesses that choose to enter the banking business will not be competitively disadvantaged.

Other policy reasons support modification of Section 4(c)(8) to permit financial services holding companies to engage in a wide range of financial and nonfinancial activities.

For example, restricting the entry of securities firms into the banking business could limit an important source of new capital for banks and reduce competition from new entrants that would likely benefit consumers.[12]

Moreover, as a practical matter, the approach taken in H.R. 1062 is likely to prevent even those securities firms only engaged in permissible financial activities from becoming affiliated with banks. This is because any such securities firm would be forced to become a financial services holding company subject to full regulation by the Federal Reserve Board. Since securities firms are already subject to extensive regulation by the SEC, the prospect of duplicative and inconsistent regulation, and the attendant costs and burdens, will act as a strong deterrent to any securities firm seeking to acquire a bank. For example, under current law a securities firm that became a bank holding company would be required to file an application with the Board before it could acquire voting share or assets of any business, to register with the Board within six months of becoming a bank holding company, to submit annual reports (including certain certified financial reports) to the Board, and to comply with certain capital standards.[13] In addition, the Board has the authority to examine bank holding

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[12] *See* Hearings concerning H.R. 1505, H.R. 6, and H.R. 15 before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance, House Comm. on Banking, Finance and Urban Affairs (April 30, 1991) (statement of Richard C. Breeden, United States Securities Exchange Commission) (where SEC Chairman Breeden stated that banks would benefit from the plentiful capital held by commercial firms). *See also* Hearings concerning H.R. 192 before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance, House Comm. on Banking, Finance and Urban Affairs (February 28, 1991) (statement of L. William Seidman, Chairman, Federal Deposit Insurance Corporation) (where Chairman Seidman stated that permitting any company to affiliate with a bank would potentially provide new sources of capital to depository institutions and that allowing banks to affiliate with financial and nonfinancial companies would contribute to the goal of "placing banks on safer and sounder financial footing over the long run.")

[13] The Institute supports the provisions of H.R. 1062 that would amend the Bank Holding Company Act to streamline the procedures that would be required for certain financial services holding companies to acquire the shares of a company or engage in new activities. These amendments, however, would not go far enough to resolve the potential for duplicative and inconsistent regulation.

companies and their subsidiaries and has general rulemaking authority over the activities of bank holding companies and their subsidiaries.

Subjecting such firms to full regulation as bank holding companies is unreasonable and unwarranted. For example, it appears that any large broker-dealer or investment adviser would be made fully subject to regulation by the Federal Reserve Board simply because it acquires a small bank. Such a result would make no more sense than would subjecting a large bank to SEC regulation because of its small broker-dealer affiliate.

Moreover, as acknowledged by Chairman Greenspan, the danger of having an umbrella supervisor like the Federal Reserve Board overseeing all of the activities of a financial services holding company is that the market may believe that uninsured bank holding company subsidiaries have available to them the subsidy implicit in the federal safety net.[14] Finally, vesting the Federal Reserve Board with this potentially duplicative oversight authority appears to be an unwise use of government resources that is contrary to more general efforts to streamline government.

The Institute urges that H.R. 1062 be revised to address these concerns. The Institute respectfully commends the approach taken in H.R. 814, the "Depository Institution Affiliation Act," for Committee consideration. This bill would provide for the creation of a new type of financial company, the "Financial Services Holding Company." A financial services holding company under H.R. 814 would be permitted to own insured depository institutions, securities firms, insurance companies, real estate companies, or any other financial or nonfinancial company. Each financial services holding company affiliate would be functionally regulated. For example, the SEC would regulate any financial services holding company securities

[14] Hearings concerning H.R. 1062 before the House Comm. on Banking and Financial Services (February 28, 1995) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System.)

affiliate.[15] The same approach was taken in the bill supported by the Bush Administration in 1991, H.R. 1505, the Financial Institutions Safety and Consumer Choice Act of 1991". In addition, in testimony before this Committee, Secretary of the Treasury Robert E. Rubin stated that the Administration supports permitting affiliations among banks, securities firms, and insurance companies. Secretary Rubin also suggested a regulatory framework of functional regulation.

The Institute would be pleased to work with the Committee on the approach taken in H.R. 814 or other alternatives that would address the need to establish competitive equality between banks and securities firms as part of the proposed reform of financial services.

VIII. CONCLUSION

The Institute supports comprehensive financial services reform legislation that recognizes all participants in the capital markets as having an interest in the future regulatory framework of the financial markets. This bill will not succeed if it is viewed as simply a bank-powers bill. The issues of competitive equality, functional regulation of bank mutual fund activities, and comprehensive investor protection under the Investment Company Act are critical to the debate, and will help to determine the outcome.

H.R. 1062 would facilitate banks' full participation in the mutual fund business and would minimize duplicative and inconsistent regulation of bank mutual fund activities by requiring coordination among the SEC and the federal banking agencies. H.R. 1062 also would functionally regulate bank mutual fund activities by establishing a set of investor protection

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[15] Unlike H.R. 1062, however, as currently drafted, H.R. 814 would not amend the Investment Company Act to add the important investor protection provisions noted above nor would it amend the Investment Advisers Act to require banks that advise mutual funds to register with the SEC. We strongly urge that H.R. 814 be amended to add such provisions.

standards for banks that advise or sponsor mutual funds parallel to those applicable to securities firms that advise or sponsor funds and by otherwise modernizing the federal securities laws to reflect bank mutual fund activities. But, H.R. 1062 does not remove unnecessary barriers to securities firms seeking to enter the business of banking; and H.R. 1062, relies far too heavily on Federal Reserve Board oversight the holding company entity.

The continued success of bank and nonbank participants in the mutual fund industry depends on the public's sustained confidence in mutual funds as a means to obtain the benefits of professional money management and diversification of investments. The Institute is committed to addressing the issues raised by bank participation in the mutual fund business, especially the need to ensure that such activities are conducted in a manner consistent with the protection of investors and subject to appropriate regulation. At the same time, we will press for securities firms to be permitted equal access to the banking business.

We thank you for the opportunity to present our views and look forward to working with the Committee as H.R. 1062 moves forward.

TESTIMONY BY

SAMUEL J. BAPTISTA

PRESIDENT

FINANCIAL SERVICES COUNCIL

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 7, 1995

Mr. Chairman and Members of the Committee, I am Samuel J. Baptista, President of the Financial Services Council ("Council").

The Council is a unique coalition representing companies from literally every sector of the U.S. financial services industry. It was formed in April of 1987 in response to the very real need for an inter-industry focus on issues involving the structure of our nation's financial system. Our sole purpose is to promote the development of an open and competitive financial services industry -- one that ensures the safety and soundness of the nation's financial system, while increasing the availability of financial products and services at fair and reasonable prices; and one that enhances the competitive posture of the U.S. financial sector in an ever more complex global marketplace. In essence, Council members seek to modernize our financial regulatory structure so that any well managed, well capitalized company, regardless of its corporate structure, would be permitted to enter or exit any sector of the financial services industry anywhere in the world. The Council's diverse membership, which includes banks, thrifts, insurance, securities, finance, and diversified companies, is committed to comprehensive, pro-competitive financial services reform in keeping with these general principles.

I am pleased to have an opportunity to present the Council's views on the issue of financial services reform. Mr. Chairman,

we commend your leadership in placing this debate back at the forefront with the introduction of H.R. 18, the Financial Services Competitiveness Act of 1995, and the revisions to it embodied in H.R. 1062. We also applaud the efforts by Representative Baker for his bill, H.R. 814, the Depository Institution Affiliation Act, cosponsored by Representatives McCollum, King, Castle, Dreier, LaFalce, Frank, and Flake. As you know, this is a companion measure to S. 337, introduced by Senate Banking Committee Chairman, Alfonse D'Amato. We are also encouraged to see the Administration come forward with its own modernization proposal. These efforts suggest that the long overdue need for financial reform may indeed be at hand.

There is no greater or more pressing issue facing our nation's financial services industry than that which is being advanced by this Committee. The ability of American financial services providers to continue to be innovative and competitive for too long has been severely hampered by anachronistic laws, regulations, and barriers to affiliation. The current system of compartmentalized financial institutions is simply not working as efficiently as it should. It does not reflect real public policy goals, but merely serves to artificially carve up markets. As a result, it is not serving households and businesses as well as it should; it is exposing taxpayers to unnecessary risks; and it has produced glaring competitive inequities. The ultimate remedies to improvement are in the hands of Congress with a critical role for this Committee, Mr. Chairman.

While the Council is encouraged by your leadership in beginning the reform process by introducing legislation to repeal the Glass-Steagall Act, redesignate the Bank Holding Company Act (BHCA) as the Financial Services Holding Company Act, expand, albeit to a limited degree, permissible activities of financial services holding companies and address some of the more onerous provisions of the BHCA that stem from its cumbersome application process, I am here to respectfully urge you and your colleagues not to stop there. I am here to discuss the merits of providing an alternative structure to the Bank Holding Company Act as well.

When we began the modernization debate, nearly a decade ago, we spoke of the radical changes in the financial services industry of the 1970's and early 1980's that necessitated such reform. Yet the developments of the past 10 years have been even more dramatic. During this time period, the government bailed out the thrift industry; commercial banks continued a loss of market share; pension funds, mutual funds, and other institutional investors became financial powerhouses, there was an explosive growth in derivative markets, and participation in foreign capital markets.

The static legal structure within which financial services operates hinders, but does not stop, market developments. The laws are porous enough to allow the competitors of banking organizations and banking organizations themselves to effectively penetrate markets which had historically been the province of

banking and to allow banks to penetrate markets reserved for other providers. Nonbank financial firms penetrated the banking business using legal loopholes and special provisions of law to buy credit card banks, industrial loan corporations, other limited purpose banks, and failed thrifts. Banks entered the securities and insurance sectors only after laborious, time consuming and cumbersome regulatory procedures. But though they are diversifying to the extent legally possible, none can truly follow their customers and compete effectively because each has limitations on its ability to provide the full menu of financial services.

Today, the marketplace no longer recognizes a special role for a commercial bank, investment bank, or insurance company. It recognizes the role of a financial intermediary. As a result, we no longer have the luxury of dealing with reform one industry segment at a time. The limitations placed on affiliations by the Glass-Steagall Act and the Bank Holding Company Act must be dealt with in tandem. Then, and only then, can an acceptable solution be developed that works not only for banking organizations but for the financial services industry as a whole.

As you look to legislative remedies, the Council would like to offer several guiding principles:

- The revised structure should remove anti-competitive barriers to affiliation that favor any industry segment and thereby limit the product offerings, marketing approaches and competition which would otherwise benefit consumers.

- The new structure should open all financial business to companies -- financial and commercial -- that meet

tests of financial soundness and prudent operation -- in order to promote new investments and capital.

- o Regulation of separate segments, subsidiaries, and affiliates under a holding company umbrella should be conducted along functional business, product, and service lines. This would serve national priorities better than the present system.

- o Holding company supervision should be minimal, residual in nature, and then related only to specific goals of public policy.

Mr. Chairman, the legislation pending before the Committee today recognizes and seeks to address the artificial barriers to competition and efficiency by updating the laws to reflect the marketplace. Your revised bill, H.R. 1062 focuses primarily on the banking and securities side of the financial equation. The Administration's proposal allows for affiliation of banking, securities, and insurance. The Baker bill, H.R. 814, addresees in a more comprehensive and fundamental fashion the competitive interplay of the entire financial services industry.

Briefly, H.R. 1062 would replace Section 20 of the Glass-Steagall Act with a new regulatory framework allowing affiliations of full-eervice banks and securities firms without product or volume limits that are now placed on bank's section 20 securities affiliats. While we believe that it continues to rely too heavily on the Bank Holding Company Act framework of regulation, it does take a significant step in the direction of a more fully integrated financial eervices model by replacing the BHCA's "closely related to banking" test for permissible activities with a "financial in nature" test. However, the bill continues to present somewhat differing alternatives depending

upon whether a company is currently a bank holding company, a securities firm or investment bank, or a diversified financial company.

While H.R. 1062 is a significant step forward from H.R. 18 in its recognition of a broader financial landscape, the Council nevertheless believes that as a result of the bill's limited approach to affiliations it remains flawed.

First, a review of the current affiliations of the majority of securities firms in the U.S. highlights the problems that result from a piecemeal approach focusing primarily on the Glass-Steagall Act. Although repeal of selected Glass-Steagall proscriptions as provided by H.R. 1062 would allow bank affiliates to engage in securities activities, many securities firms would likely be unable to acquire or affiliate with a commercial bank due to the retention of specific activities restrictions contained in Section 4 of the Bank Holding Company Act. Many financial services providers, including companies like Kemper, American Express, USAA, Prudential and Travelers would not qualify to become this new financial services holding company because of affiliations with insurance underwriters or affiliation with entities engaged in activities that may not be financial in nature.

Second, while the new proposed Financial Services Holding Company can engage in activities that are determined by the Federal Reserve Board to be "financial in nature" it provides no guidance to the Board in making that determination and no direct

input by other regulatory bodies. This ambiguity would lead to continued confusion and uncertainty within financial markets. There are neither existing legal standards nor precedent as to what specific activities would constitute being of a financial nature. Thus the Council urges that if such a test is imposed for permissible financial services holding company activities, a functional definition that includes, without limitation, examples of such activities should be proffered in the new statute. At a minimum, activities of a financial nature must be more inclusive than the existing standard embodied in section 4(c)(8) of the Bank Holding Company Act. They should also permit and even encourage the development of new products and services that take advantage of, or rely upon, emerging technology.

As the financial services industry moves further into technological manufacturing and delivery of products, the line between what is financial and what is not becomes blurred. Furthermore, the fact that some limited insurance activities are explicitly included while many other such activities continue to be excluded will invariably lead to more unproductive, costly litigation as interested parties attempt to enter new fields or protect existing turf. It simply makes no sense to exclude insurance from being "financial in nature" when the market clearly dictates that it is. Under this construct the Federal Reserve Board could determine that Microsoft was a financial concern but would be precluded to make the same determination for Travelers, Aetna, AIG, New York Life, Prudential, Providian,

USAA, Kemper, etc. These are not just insurance companies, they are, in the eyes of the marketplace, financial services holding companies. To foreclose their inclusion within a new statutory framework for financial services holding companies is countarintuitive to the realities of the marketplace. And the fact that many securities firms have either significant insurance or commercial affiliations makes the proposal unworkable for part of the industry it was supposed to include. As a result, the bill falls short of the very modernization it purports to accomplish.

Moreover, by building on the existing Bank Holding Company Act structure, existing restrictive holding company regulation is perpetuated. Rather than concentrating on supervision of the insured depository institution, regulatory attention will continue to be focused on the activities of the holding company. Effective oversight of prudential activities and bank safety and soundness is more appropriately directed by looking first and foremost at the activities and operations of the insured depository and secondarily at its transactions and dealings with affiliates. Thus, the Council believes that regulation should be focused from the bank outward versus the top down regulatory model that exists today with the Bank Holding Company Act and would continue to exist under the new Financial Services Holding Company Act contemplated by H.R. 1062.

To the extent that any umbrella oversight is needed as Federal Reserve Board Chairman, Alan Greenspan, suggests, we

believe that such authority would be more properly vested with a committee similar to the National Financial Services Oversight Committee contemplated under the Baker bill and comprised of the various federal functional regulators. This would both complemsnt and coordinate the notion of functional regulation. If, based on information it receives on the financial condition of the holding company, the Committee has reason to believe a problem exists in an organization that poses a threat to the safety and soundness of the depository institution it should direct such concern to the appropriate functional regulator.

The Council is also troubled by section 104 of H.R. 1062 which repeals the unitary savings and loan holding company exemption from the activities restriction of section 10 of the Home Owners Loan Act. This exemption has allowed a commercial or diversified financial services company to control a thrift. Unitary thrift holding companies have brought strength and stability to thrift industry and have demonstrated how companies with affiliations that fall outside the Bank Holding Company Act can bring capital and managerial expertise into the banking sector. The grandfathering of companies that controlled unitary thrifts on January 4, 1995, while better than requiring divestiture, denigrates the value of thoee thrifts and restricts companies from entering and exiting businesses as they choose or the market dictates. This will further restrict the flow of new capital to the thrift industry at a time when, given the expected deposit insurance assessment disparity, investments in thrifts

will become significantly less attractive. We urge the Chairman to drop this provision from his bill.

In contrast, the bill introduced by Mr. Baker, H.R. 814, is fundamentally more market-oriented and recognizes the competitive needs of the entire financial services industry. It would permit any type of company, including a commercial company, to affiliate with a bank or thrift, provided it becomes a FSHC and complies with the Act's regulatory and supervisory provisions. It would, therefore, also permit bank holding companies to expand into all types of financial and commercial activities.

In short, H.R. 814 would:

- permit any firm to offer a full range of financial services to its customers through separately capitalized affiliates, provided that its depository institutions were at all times healthy and well-capitalized

- require banking and nonbanking activities to be conducted through separate subsidiaries of a holding company, the bank itself would not conduct the new activities;

- regulate each affiliate functionally -- banks would be regulated by bank regulators, securities firms by the SEC, insurance firms by state insurance regulators, and so on;

- require a parent holding company to infuse capital into its depository institutions or face divestiture should the depository ever fail to meet its capital standards;

- mandate early intervention by the regulators;

- strengthen regulation and oversight.

No deposit insurance funds may be used to "bail out" a nondepository affiliate. Should a depository fall below well-capitalized, the depository's regulator is required to step in

and obtain an infusion of capital from the parent company to bring the depository's capital up to the required minimum. The bill does not allow the regulators to wait until capital reaches 1 or 0 percent. If the parent does not present an acceptable plan to keep the depository well capitalized, the parent will lose the depository -- while it is still a viable, healthy, ongoing concern.

Supervision of the depositories is improved in other ways, too. Regulators are given additional enforcement tools up to and including additional divestiture authority in the event that they detect a pattern of violations that could threaten the safety and soundness of any depository institution controlled by a FSHC.

Transactions between depositories and their affiliates would be restricted by Sections 23A and 23B of the Federal Reserve Act. (see Attachment). Under 23A, banks may lend a maximum of only 10% of their capital to any affiliate and only 20% of their capital to all their affiliates. These loans must be fully collateralized. Section 23B requires that all transactions between a bank and its affiliate must be done at arm's length. Thus, loans between a bank and its nonbank affiliates are sharply limited and no "sweet deals" between banks and the nonbank affiliates may be conducted at all. Furthermore, a loan to an affiliate could never be of a size to jeopardize a bank. There are strong civil and criminal penalties to encourage compliance as well as cease and desist authority to ensure compliance.

While the Council fully supports the structure contemplated

by H.R. 814 it does, however, contain a number of so-called "firewalls" that we believe are overly rigid and unnecessary. These restrictions would prohibit any depository institution in a FSHC from extending credit to a securities affiliate or its subsidiary, purchasing for its own account assets of a securitiee affiliate or its subsidiary, issuing a guarantse, acceptance or letter of credit for the benefit of a securities affiliate or its subsidiary, and extanding credit to an investment company advised by or the shares of which are distributed by a securities affiliate. The Council does not believe that these restrictions are necessary given the breadth of authority granted the bank regulator to refine and/or expand on the safeguards contained in 23A and 23B. At a minimum, the bank regulator must be provided enough flexibility to provide exceptions for any statutory firewalls that may be enacted in order to accommodate changing conditions dictated by the marketplace.

I would now like to take a few minutes to address some of the concerns expressed in last weeks hearings regarding comprehensive reform.

BANKING AND COMMERCE

One of the primary philosophical distinctions between the approach of Chairman Leach and that of Mr. Baker is the allowance for affiliations between financial and commercial firms. Under the Baker legislation, commercial firms can affiliate with banks and banks can affiliate with commercial firms under the auspices

of a financial services holding company.

Affiliations between commercial firms and banks is not a radical concept in our country. Banking and commerce have been mixed in the U.S. since our country's birth. Today, most of the commercial firms which own limited purpose banks or thrifts do so because have chosen to diversify into financial services and the affiliation allows them to more fully serve their custosers needs.

In a 1987 study, the FDIC noted that "there has never been a complete separation of finance and commerce in the history of American banking." The law has always permitted individuals to own controlling interests in both a bank and a commercial firm, and throughout American history individuals have simultaneously owned and in many caees managed both a bank and a commercial firm. Thus, an individual on Main Strest can own the only bank in town as well as the only insurance agency, real estate agency, car dealer, and hardware store. Yet, publicly traded companies may be prohibited from having such affiliations simply because of their corporate structure. Surely, if restrictions on affiliations with commercial banks are appropriate for publicly traded companies subject to the rigors of market regulation by our nation's rating agencies they should apply to individuals whose activities and financial conditions are subject to far less scrutiny.

Considerable attention has been given to the perceived threats associated with commercial firms entering the banking

industry. One of these perceived threats has its origins in the "robber baron" images of the late 1890's - that a commercial firm would purchase a bank and then turn around and deny credit to its competitors. A century later, this could not happen. Access to credit for U.S. companies is available 24 hours a day around the world. Another concern is besed in the assumption that commercial owners of banks would somehow circumvent U.S. banking laws designed to ensure fair lending, competition, and the safety and soundness of our banking system. Let us not forget that many commercial firms through their ownership of thrifts and limited-purpose banks have been complying with these statutes for years.

If the issue is concentration of financial resources, it would be simple enough for Congress to prohibit the merger of two giants from the commercial world end the banking world. If the issue is the protection of the depository institution from dealings with the commercial parent company, then erect appropriate firewalls to prohibit such transactions.

CONCERNS OF COMMUNITY BANKS

Concerns have been expressed about how community banks would fare if a new structure for financial services were adopted that removed all barriers to affiliation. The fact is, many community banks may want to take advantage of affiliations with local securities firms to buy, sell, or underwrite securities issued by regional entities. Others may want to affiliate with an insurance agency. Small and modium sized businesses will be

better served by these newly affiliated companies. For those banks that do not want to take advantage of the new structure, they will continue as they do today. It is not their place to say no to others simply because they do not want competition or do not have the need to restructure themselves.

The evidence clearly shows that both big and small, diversified and specialized financial firms compete side-by-side in markets where they are permitted to do so. Community banks in New York, California, and Washington have prospered compating with big banks such as Citibank, Chase, BancOne, Nations Bank and Bank of America.

SUMMARY AND CONCLUSIONS

The taxpayers - your constituents - our customers would benefit from a comprehensive financial services holding company structure. The safety and soundness of the entire financial system would be strengthened; there would be open and fair competition in the domestic financial services marketplace; and American suppliers of financial services would become more competitive worldwide. A more efficient and stable financial system will be better able to serve the needs of individual consumers, businesses, and governments in the U.S. and around the world.

Although all financial services have the same common elements, law, and tradition have treated banks as if they were special. The contracts depositors have with their depository

institutions are insured by a federal agency. Depository institutions also have access to federal agencies for their funding needs in times of trouble. These advantages justify federal regulation. But regulations restricting the ownership and affiliations of depository institutions are counterproductive and thwart the goal of ensuring safety and soundness.

H.R. 814 relies on strict application of meaningful capital standards and prompt reorganization of capital-impaired depository institutions to protect the safety and soundness of depository institutions, and the deposit insurance funds. These provisions, combined with the removal of restrictions on affiliations and ownership of depository institutions, will contributa to an efficient, adaptable, and safe financial system that will add to the competitiveness and productivity of the U.S. economy.

The benefits of competition -- the market constraints on prices, the incentives for efficiency and innovation, and the dispersion of economic power -- are widely recognized. Only through comprehensive structural reform can we achieve these vital public policy goals.

ATTACHMENT

EXISTING FIREWALLS BETWEEN INSURED BANKS AND SECURITIES AFFILIATES

In recommending the repeal of the Glass-Steagall Act committees of the House and the Senate have included in their respective bills certain transactional prohibitions and disclosure requirements to protect insured banks and consumers from any dangers inherent in permitting banks to affiliate with securities firms However, since Glass-Steagall has never been a total prohibition to insured national or State member banks being affiliated with companies engaged in securities activities (and is not applicable to State nonmember banks) current federal law and regulation already provides significant safeguards to deal with such affiliations. Thus, the concerns that the House and Senate committees have sought to address in the "firewalls" they have constructed to accompany the repeal of Glass-Steagall, are already adequately addressed under current law and regulation pursuant to section 23B of the Federal Reserve Act (applicable to all insured banks) and the FDIC s regulations under 12 CFR Part 337 (applicable to insured nonmember banks).

Section 23B

- An insured bank, whether acting as principal or fiduciary, is generally prohibited from purchasing or otherwise acquiring, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank; except that, an insured bank may purchase or acquire such securities if, before the securities are initially offered for sale to the public, the acquisition has been approved by a majority of the banks directors who are not officers or employees of the bank or any affiliate thereof.

- The term "principal underwriter" means an underwriter who, in connection with a primary distribution of securities i) is in privity of contract with the issuer or an affiliated person of the issuer ii) acting alone or in concert with other persons, initiates or directs the formation of the underwriting syndicate, or (iii) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

- An insured bank is prohibited from purchasing as fiduciary, any securities or any assets from any affiliate unless such purchase is permitted under (i) the instrument creating the

fiduciary relationship, (ii) a court order, or (iii) by law of the jurisdiction governing the fiduciary relationship.

- An insured bank or any subsidiary or affiliate of an insured bank shall not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates.

12 CFR Part 337.4

- The securities business of a company affiliated with a bank must be physically separate and distinct from the operation of the bank; if the affiliate conducts business in the same location as the bank, the affiliate must utilize physically separate offices or office space not used by the bank; the offices must be clearly and prominently identified so as to distinguish the affiliate from the bank. 337.4(c)(1)

- The bank and the securities affiliate can share no common officers. 337.4 (c)(2)

- The majority of the board of directors of the bank must be composed of persons who are neither directors or officers of the securities affiliate. 337.4(c)(3)

- Any employee of the securities affiliate who is also an employee of the bank may not conduct any securities activities on the behalf of the affiliate on the premises of the bank that involve customer contact. 337.4(c)(4)

- The securities affiliate must conduct business pursuant to independent policies and procedures designed to inform customers and perspective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered, or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank or otherwise obligations of the bank. 337.4(c)(5)

- A bank which has a subsidiary or affiliate engaged in dealing or underwriting in securities or acts as an investment adviser to an investment company may not purchase as fiduciary, any security currently distributed, underwritten, or issued by such subsidiary or affiliate or issued by an investment company advised by such subsidiary or affiliate unless (i) the purchase is expressly authorized by the trust instrument, court order, or local law or specific authority is obtained from all interested parties after full disclosure, (ii) the purchase although not expressly authorized, is otherwise consistent with the bank's fiduciary obligation, or (iii) the purchase is

permissible under applicable, federal and/or state statute or regulation. 337.4(e)

- A bank may not transact business through its trust department with a subsidiary or affiliate engaged in dealing or underwriting securities unless the transactions are at least comparable to transactions with an unaffiliated securities company or securities company that is not a subsidiary of the bank. 337.4(e)

- A bank with a securities subsidiary or affiliate may not extend credit or make any loan directly or indirectly to any company whose securities are currently being underwritten or distributed by such subsidiary or affiliate of the bank unless the company's securities qualify as investment grade securities 337.4(e)

- A bank with a securities subsidiary or affiliate may not extend credit to any investment company whose shares are currently underwritten or distributed by such subsidiary or affiliate. 337.4(e)

- A bank with a securities subsidiary or affiliate may not extend credit for the purpose of (i) acquiring securities currently underwritten or distributed by such subsidiary or affiliate, (ii) acquiring any security currently issued by an investment company advised by such subsidiary or affiliate, or (iii) acquiring any security issued by such subsidiary or affiliate except extensions of credit to employees for the purpose of acquiring securities through an employee stock bonus or purchase plan. 337.4(e)

- A bank with a securities subsidiary or affiliate may not extend credit to a securities subsidiary or affiliate of the bank or to an investment company advised by an affiliate or subsidiary of the bank except in accordance with the limitations imposed under section 23A. 337.4(e)

- A bank may not condition any loan or extension of credit to any company on the requirement that the company contract with the bank's subsidiary or affiliate to underwrite or distribute the company's securities or condition an extension of credit to any person on the requirement that that person purchase any security currently underwritten or distributed by the bank's subsidiary or affiliate. 337.4(e)

- Any securities subsidiary or affiliate of a bank that (i) shares the same or similar name or logo with the bank, (ii) conducts business in the same location as the bank, or (iii) jointly markets with the bank, must disclose to its customers and prospective customers that securities

recommended, offered or sold by it are not FDIC insured deposits (unless otherwise indicated), that such securities are not guaranteed by, nor obligations of, the bank and that the subsidiary and/or affiliate are separate organizations. Any required disclosure to a customer of a securities subsidiary or affiliate of a bank must be prominent, in writing, and made upon opening an account relationship (and semi-annually thereafter in customer statements). 337.4(h)

- Form of statement that will satisfy disclosure requirement is as follows: "[name of affiliate/subsidiary] is not a bank and securities offered by it are not backed or guaranteed by any bank nor are they insured by the FDIC." 337.4(h)(2)

STATEMENT OF THE

AMERICAN FINANCIAL SERVICES ASSOCIATION

BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES

MARCH 7, 1995

The American Financial Services Association appreciates this opportunity to express our views on H.R. 1062, "The Financial Services Competitiveness Act of 1995".

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional, market-funded providers of financial services to consumers and small businesses. As adopted by our members, the mission of AFSA "is to assure a strong and healthy broad-based consumer lending services industry which is committed to (1) providing the public with a quality and cost effective service, (2)promoting a financial system that enhances competitiveness and (3) supporting the responsible delivery and use of credit and credit related products".

AFSA's members fit into four basic categories:

- Diversified Financial Services Companies -- These are companies that offer a broad range of financial services and products to consumers nationwide. Many of these members are affiliated with banks or savings and loans.
- Automotive Finance Companies -- These companies are frequently referred to as "captive finance companies". They provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or

their parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

- Consumer Finance Companies -- The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.

- Credit card issuers -- This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include some of the largest credit card issuers in the U.S.

Some consumer finance companies are owned by, own, or are affiliated with depository institutions, such as savings & loans, consumer banks (limited-purpose banks), or credit card banks. These institutions are fully regulated institutions, subject to all of the laws and regulations applying to banking institutions, including the Community Reinvestment Act and the Home Mortgage Disclosure Act. They are regularly examined by state and federal banking authorities.

In addition, each of these consumer lenders must comply with federal regulations relating to consumer credit - the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, and the Federal Trade Commission's Credit Practices Rule are among the most important.

Consumer lenders which are not depository institutions, are generally licensed and regulated by the state banking department or the department of corporations in every state in which they operate, often separately regulated for each product. They are subject to state laws governing the rates they can charge on consumer loans, as well as state consumer protection laws.

As the above demonstrates, AFSA members are important sources of credit to the American consumer, providing between 10 and 15 percent of all consumer credit. AFSA members are highly innovative and compete at all levels in the financial services markets. As reflected in our mission, our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

H.R. 1062 "The Financial Services Competitiveness Act of 1995"

H.R. 1062 constitutes a significant change in holding company activities and regulation. The bill establishes a "Financial Services Holding Company" ("holding company") and permits the holding company to have securities affiliates engaged in a full range of securities and investment advisory activities. In addition, the bill permits the establishment of an "Investment Bank Holding Company" that may control a "Wholesale Financial Institution", and a firm engaged in a full range of securities and investment advisory activities. The bill also amends Section 4(c)(8) of the Bank Holding Company Act to permit the holding company to engage in activities which are "financial in nature or incidental to such financial activities". With certain exceptions, this does not include insurance activities, although the bill does permit, with certain constraints, a holding company to control "nonconforming financial companies" as long as the aggregate investment in such companies does not exceed 10 percent of the total consolidated capital and surplus of the holding company and as long as more than 50 percent of the business of the holding company in the two years prior to its becoming a financial services holding company involved securities activities.

In addition to the above activities reforms, the bill also makes significant reforms in the regulatory process. The bill basically replaces the current Federal Reserve application process
with a notice process with reasonable safety and soundness constraints.

Outside of the financial services holding company activity and regulatory reforms, the bill also provides limited relief from anticompetitive restrictions on financial institutions established by the Competitive Equality Banking Act of 1987 ("CEBA"). Section 103(h), for example, establishes an exception to the asset growth limitation imposed on "nonbank banks" by the Competitive Equality Banking Act of 1987. The growth cap would be relaxed for such institutions only if (1) each depository institution with which it is affiliated is well-capitalized, (2) the parent company only engages in the activities permitted for a financial services holding company (and insurance activities under certain circumstances), and (3) after having written notice of such intended growth, the Board does not object to the company's proposal in accordance with the Board's new review procedures. The securities firewalls established for "nonbank banks" which are affiliated with securities concerns would be no less stringent than those required for other insured depository institutions.

COMMENTS ON H.R. 1062

The American Financial Services Association appreciates and acknowledges the reforms made by H.R. 1062. It is a step forward and we understand that a great many political and jurisdictional considerations were involved in the policy choices that were made. As we read the bill, the primary tier of benefits would flow to larger wholesale banks and investment banks. These institutions would presumably enjoy greater economies of scale and a strengthened competitive position in global capital markets. To the extent that this lowers the overall cost of capital, it should benefit already competitive, efficient market funded and regulated lenders, such as those represented by AFSA, by lowering their cost of funding. Other than lowering funding costs, it does nothing to make highly regulated and inefficient insured institutions more efficient and competitive.

The bill would also benefit institutions without commercial and substantial insurance affiliations who wish to become a financial services holding company. While the bill retains the Federal Reserve as the holding company regulator, the bill's intent is to provide a notice procedure as opposed to the current application procedure so that these entities may function somewhat more like normal businesses. The bill makes substantial steps in that direction although some subtle issues remain which we hope to address with the Committee as the process continues. While H.R. 1062 changes the regulatory process, the culture of the regulator is another matter; the Federal Reserve is a bank regulator and has viewed any non-traditional affiliations or activities more critically. As Jim Robinson testified last week before the Subcommittee on Capital Markets, the Federal Reserve needs to become a "financial services" regulator, and that will be a difficult transition for them to make.

The Investment Bank Holding Company established in the bill, while not presently of direct interest to most AFSA members, provides a useful approach for dealing with deposit insurance concerns for certain activities while providing some other benefits the present banking system confers upon its member banks. Where deposit insurance is not a factor, there is no reason to restrict affiliations. AFSA would urge the committee to explore what other kinds of uninsured institutions could be established that might meet various needs in our financial markets.

AFFILIATIONS-- Insurance and Nonfinancial Commerce

The affiliation issue is at the root of one of AFSA's primary concerns with H.R. 1062. As indicated at the beginning of the testimony, AFSA represents an extremely diverse group of lenders, primarily market funded and accordingly subject to intense scrutiny and regulation by the markets. A great many of these entities have a wide range of affiliations with some type of federally insured institution. Virtually all of these affiliations have been in existence for some time with varying degrees of anticompetitive functional constraints imposed by federal law and regulation. There has never been any evidence that any of these entities pose any systemic or

deposit insurance risk as they go about their business of providing between 10 and 15 percent of all consumer credit.

At the very least, a true financial services holding company should include insurance-- it is difficult to argue that insurance is not "financial in nature or incidental to such financial activities".

Beyond insurance, AFSA strongly supports the ability of commercial firms to own or otherwise affiliate with such a holding company. The issue of mixing banking and non-financial commerce has become an overblown theological issue when it really is at most a competitive inequity susceptible of legislative solution. The prohibition on banking and commerce has always been shot through with exceptions-- especially at the small bank level-- and none of these exceptions-- at least at the level of significant publicly owned corporations-- have given rise to any problems, let alone problems that would justify the federal prohibition. Thousands of individuals own banks-- large and small-- who also own many and varied commercial interests, none of which are subject to the same holding company affiliation restrictions and oversight as banks owned by corporate entitities. It is difficult to understand why individuals should not be subject to the same banking and commerce restrictions as corporate owners, if the proximity of banking and commerce truly is a mortal threat to the banking system. If it is harmful for bank and commercial entities owned in the commercial form to affiliate, and AFSA does not think that it is, then the same restrictions should apply to the thousands of wealthy individuals who freely mix banking and commercial enterprises.

The primary argument postulated against banking and commerce is that such a holding company form would result in large concentrations of economic resources, in addition to having the potential for conflicts of interest between the bank and the non-bank entitities that would pose undue risk to the bank and the federal deposit insurance funds.

AFSA believes that this argument has little merit, especially in the context of the global marketplace in which our financial services industry now competes.

Concentrations of economic resources are far more likely to occur in small towns where, as described above there is only one bank owned by an individual who also owns other major economic units such as the local independent insurance agency, car dealer, feed store, etc.. Economic concentration, particularly in today's global market, is not just size but size in relation to the market in which the entity operates. A very large institution, operating nationally and internationally, is subject to competition at every size level, from the smallest independent bank to the largest Japanese bank.

Size alone should not be an indicator of concentration and should not determine holding company activity restrictions. Size in a domestic market is a problem only if that market is protected from competition or if market forces are otherwise weak. The types of domestic financial institutions permitted by H.R. 1062 will probably, in general, be much larger than any heretofore able to exist. In today's global financial services market, larger institutions are a necessity. While AFSA feels that this H.R. 1062's limited approach will be beneficial to our international competitiveness, we don't feel that the benefits of modernization should stop at this point.

In terms of risk to the bank and insurance fund from such a diversified structure, the experience with life insurance holding companies is instructive. In its 1988 report, *Modernization of the Financial Services Industry: A Plan For Capital Mobility Within A Framework of Safe and Sound Banking*, the Committee on Government Operations of the U.S. House of Representatives found that:

> " A close parallel exists between the temptations a financial services holding company would face to draw on the resources of its bank subsidiaries in a time of difficulty and the similar temptations that face the managements of existing life insurance holding companies under similar circumstances. Life insurance companies resemble banks in the sense that they are closely regulated for safety and soundness, and their obligations to policy beneficiaries are protected by a form of State-supervised insurance. There is thus the obvious danger that a holding

company, one of whose other subsidiaries is having financial difficulties may try to obtain additional funding for the troubled affiliate from the resources of the insurance company.

This potential threat to the resources of these insured institutions has not, however, prevented the the formation of life insurance holding companies combining within the same corporation, major life insurers, major securities firms, major mutual fund organizations, and other substantial financial and nonfinancial operating companies. ... To accomodate this movement toward holding company formations, a pattern of State regulation of the affairs of the life insurance companies and their interaffiliate dealings has been established that seeks to insulate the life insurers and without imposing substantive operating restraints on the affiliated companies or the parent holding company.

...The Committee finds, therefore, that the State regulatory experience with life insurance holding companies, in which the insurance companies are protected from abuse without destroying the apparent synergies and incentives for holding company affiliations, lends substantial support to the committee's conclusion that effective insulation of banks can be made fully compatible with the fundamental objectives of financial services holding companies".
(H.R. REP. No. 100-324., 100th Congress, 1st Sess., 43-44, (1987)).

AFSA feels that the experience of the states with life insurance holding companies is instructive and urges the committee to take a close look at this model. H.R. 814, the " Financial Services Depository Institutions Act of 1995" introduced by Congressman Baker draws significantly from this model and provides a good blueprint for how different affiliations can be accomodated and we strongly urge the Committee to seriously explore the expansion of affiliations within a holding company structure.

ANTI- COMPETITIVE RESTRICTIONS CONTAINED IN THE "COMPETITIVE EQUALITY BANKING ACT OF 1987"

In terms of the limited relief provided by H.R. 1062 from the growth cap and affiliate transactions restrictions contained in the "Competitive Equality Banking Act of 1987", AFSA greatly appreciates the Chairman's initiative on this issue. Especially in light of the affiliation restrictions in the Financial Services Holding Company established by H.R. 1062 and the total lack of affiliation restrictions on individuals as discussed above, AFSA strongly believes that the asset growth limitation, as well as other CEBA restrictions, should be eliminated for all grandfathered CEBA limited purpose banks. The growth cap is a gratuitous and anticompetitive restraint on legitimate financial institutions. It is unheard of for any free enterprise to be hobbled by such legislative restrictions.

Limited-purpose "CEBA banks" are institutions whose ownership by entities that are not bank holding companies was grandfathered under CEBA, provided that the banks comply with a number of restrictions. These include: a restriction on engaging in both demand deposit taking and commercial lending, a limitation on crossmarketing with affiliates, a restriction on engaging in activities in which the bank was not engaged on March 5, 1987, a restriction against creating "daylight overdrafts" on behalf of affiliates, and a limitation on asset growth to 7% annually. These banks are, however, subject to the same capital requirements, supervision, community reinvestment obligations, consumer protection laws and other banking laws as full-service banks.

The CEBA restrictions were characterized as temporary, and Congress stated that they would be reconsidered as part of "comprehensive" banking legislation that addressed such issues as interstate banking, and the ability of full-service banks to engage in securities, insurance and real estate activities. The purpose of the restrictions, according to CEBA, was to permit Congress, rather than the regulators or the courts, to more clearly define how financial services providers were to be regulated, to encourage limited purpose banks to support this effort, and to maintain both the competitive and safety and soundness status quo pending consideration of such legislation.

Unfortunately, in the 8 years since CEBA's enactment, Congress has not enacted a "comprehensive" financial services law, and the restrictions on limited-purpose banks remain in place. Nevertheless, there have been many changes that make the retention of these restrictions, particularly the growth cap, unnecessary. These include: (1) a significant decline in the number of limited-purpose banks (from about 160 to 23), which reduces their competitive impact and facilitates regulators' ability to supervise them; (2) the enactment of important banking laws in 1989 and 1991 that enhance regulators' ability to insure that these (and other) banks are run in a safe and sound manner, including authority to freeze bank asset growth if capital levels decline, (3) the enactment in 1994 of interstate banking legislation which allows full service banks to compete geographically with limited-purpose banks and their owners, and (4) the approval by bank regulators, and the courts, of a growing list of securities, insurance and other financial services activities permissible for banks. These changes, occurring while limited-purpose CEBA banks have remained subject to onerous limitations on their growth, activities, and relationships with affiliates, address the concern expressed in 1987 about banks' ability to compete "on a more equal basis" with limited-purpose banks.

Again, if the Committee does not choose to expand the affiliations in H.R. 1062, AFSA would strongly urge that simple fairness and competitive equity compels the complete lifting of the CEBA restrictions.

DEPOSIT INSURANCE REFORM

In addition to AFSA's concern over the limitations on affiliations contained in H.R. 1062, as well as the limitations on CEBA relief, the more general concern that AFSA has is that the bill does not do enough to bring market discipline to the insured portion of the industry nor does it does it address the overriding issue of deposit insurance. AFSA feels that Congressman Baker's bill, H.R. 814 does more to increase market discipline, while allowing greater affiliations although it does not take the issue of deposit insurance reform head on.

AFSA believes that its members who are primarily *market funded*, and who have a wide range of affiliations, offer an excellent illustration of the effectiveness of market regulation for the commercial ownership of financial institutions. AFSA regrets that the debate on financial modernization has not yet focussed on both the issue of how more market regulation can be injected into the federally insured part of the financial system, and on who should close weak or failing insured institutions -- the markets or the regulators. AFSA believes that the experience of financial institutions funded in the commercial paper market provides a blueprint for increased competition and availability of financial products as well as a rapid, highly effective discipline of unsound risk-taking combined with an exit mechanism for weak or failing institutions that only impacts shareholders and management, without significant systemic risk.

REGULATION OF MARKET FUNDED LENDERS THROUGH THE COMMERCIAL PAPER MARKETS

Fundamental Characteristics of Market Funded Lenders

The fundamental difference between market funded lenders and banks is the nexus of their relationship with local communities. Banks' relationships with local communities emanate from their deposit base. Market funded lenders enter local communities through their lending activities,
funded by the capital markets.

In the typical banking model, a bank generates funding for its lending activities from deposits gathered in by local offices. It then lends these funds locally or, if local demand is not sufficient or the bank elects to focus outside the community, the bank lends in other markets, buys securities, or places the funds in the federal funds markets (i.e., lends to other banks throughout the nation).

Clearly, there are exceptions to this pattern, especially among larger, wholesale oriented banks[1]. Nevertheless, in the context of consumer lending, this model gives a good picture of the funding and lending dynamics.

The model for the typical market funded consumer lender is, in a sense, opposite. These companies raise their funds in global capital markets by issuing commercial paper and medium and long term debt. To reduce their cost, their commercial paper is often backed by bank back-up lines of credit, the same way that non-financial corporations rely on bank back-up lines of credit to enhance their credit ratings.

As in the case of the banks, there are exceptions to this model, but again, it is a good representation of the funding and lending dynamics.

What these models show, very simply, is that banks generate funds locally, largely from consumers and small businesses, to lend inside or outside the local market, while market funded lenders raise funds worldwide to lend into local consumer and small business markets. This fundamental difference between the two groups is the basis for many of the institutional distinctions between them. Further, as illustrated throughout this paper, that difference is the primary reason that market funded lenders should not be regulated like banks.

Market Oversight

The performance of publicity traded banks, thrifts, and market funded lenders is followed closely by the capital markets. Their debt securities are rated by the rating agencies such as Moody's, Standard and Poor, and Fitch. However, there is a key difference between depository institutions and market funded lenders. If the markets lose confidence in a bank or thrift, the

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[1] One exception to this model is funding by securitizing assets. In this process, the institution pools receivables and sells them as a security to investors, thereby raising new funds. This type of funding is becoming increasingly popular with all lenders, including banks. To the To the extent that this reduces the importance of deposit funding, it means that banks are becoming more like the market funded lenders, not vice versa.

institution can still operate by raising deposit funds. In the 1980s, numerous banks and thrifts continued to operate even though their market ratings were well below investment grade. In contrast, if the markets lose confidence in a market funded lender, it may no longer have the ability to fund its activities and to grow-- it must shrink and ultimately may be forced to close.

An important source of funding for market-funded lenders is commercial paper. Commercial paper is short term, unsecured debt sold by corporations with good credit ratings. Commercial paper is generally issued to large investors. All types of corporations issue commercial paper, including manufacturers, transportation companies, banks, and finance companies.

Because the maturity of commercial paper is so short, 270 days or less, issuers usually expect to roll it over at maturity rather than pay it off. However, to obtain a higher rating for their debt by providing additonal insurance that they have liquid funds available in the event that conditions change and they must repay their paper, the issuers obtain back-up lines of credit for a fee from banks, although this practice is decreasing. It is important to note that the actual risk of loss to banks is extremely low. Their role is to be ready to provide liquidity, but in most back-up arrangements they can restructure the debt to secure their interest to should the issuer face financial difficulties. Even that is unlikely, since only high grade corporations are accepted commercial paper issuers. In particular, the finance company issuers have high levels of capital which protect the banks against potential losses. Further, many finance company obligations are guaranteed by strong parent companies. Commercial paper defaults have been extremely rare, as have failures of finance companies.

The Westinghouse Credit Corporation is a good example of how the market resolved a potential problem. As a result of large loan write offs in the early 1990s, Westinghouse Credit experienced large losses. The company lost its credit rating and could no longer issue commercial paper; the credit rating of the parent company was impaired and it was forced to downstream capital to the finance company. The company drew down its lines of credit at about 50 foreign and domestic banks. These lines were restructured into secured lines. The

liquidation was orderly and quick without crisis. Throughout the process, the parent, Westinghouse Electric stood behind the debt of its subsidiary.

As the Westinghouse example illustrates, it is absolutely critical to market funded lenders that they be well regarded by the market. It is in that sense that the market regulates their financial viability and this regulation of safety and soundness is swift, with no excuses.
The Westinghouse example is one where the subsidiary impaired the parent and the subsidiary was forced to shrink and close. However, market discipline works in the opposite direction as well. There have been several instances where the manufacturing parent of the finance company encountered financial difficulty and received an impaired credit rating. Even though the subsidiary finance companies were doing extremely well, they were forced to shrink significantly. The Federal Reserve has been trying to implement a similar "source of strength" doctrine for banks and the bank holding company for some time. The market is considerably ahead of it, even with all of the bank regulatory improvements that have been made since 1989.

Failure Resolution

The fundamental difference between banks and market funded consumer lenders explains the dramatic difference in incidence and resolution of failures of the two groups of institutions. Banks are funded primarily through deposits. As the experience of the 1980s clearly illustrates, banks can continue to maintain and even increase insured deposits while the quality of their assets is severely deteriorating. The S&L debacle gave an even clearer picture of how insured depository institutions can grow despite severe asset quality problems At some point, the bank's liabilities may even exceed the true value of its assets. When this occurs, or hopefully somewhat sooner, the regulators must close or merge the bank. The regulators' goal is to protect the deposit insurance fund from losses. That requires that their primary focus be on ensuring the safety and soundness of the banks to avoid their failure and potential losses to the insurance fund. If the bank's assets are not sufficient to cover the insured deposits, the difference must be made by the FDIC's bank insurance fund. Insured depositors funds must be protected, by law.

In contrast, the failure of a market funded lender is borne solely by its shareholders and debt holders. Neither its customers, nor the government, nor the tax payers are directly affected.

Second, the market typically requires that the market funded lenders hold more capital relative to assets than banks. As of year end 1993, the medial ratio of equity to assets for bank holding companies with assets of $10 billion or above was 7.95%. The median for the largest 20 publicly held finance companies (ranked by total capital) in 1993 was 11.97%. Attached is a recently released chart showing that a representative sampling of finance companies had average equity to assets almost double that of a representative sampling of banks.

Liabilities Growth

The growth of finance company assets over the past fifteen years was financed largely with funds from the burgeoning securities markets. Unable to issue deposits, finance companies raised funds largely in the commercial paper (CP) and corporate bond markets. At first, the CP market was the primary source of funds, with money market mutual funds allocating major portions of their portfolios to highly rated commercial paper. Finance companies became by far the largest issuers in the CP market. The outstanding amount of CP by finance companies grew an average of 12 percent a year from 1980 to 1990 and stood at $153 billion by the end of the period. In the second half of the decade, total liabilities grew more slowly, but corporate bond issuance surged 14 percent.

Importance of the Corporate Parent

A finance company's credit rating depends not so much on its own capitalization as on the existence of a parent and the perceived capital strength of that parent. Some of the strongest parents are commercial or industrial firms. Financial ties to such parents often help raise a finance company's credit ratings and thus lower its borrowing costs, a benefit of ownership that is not institutionally available to commercial banks.

Bank & Finance Company Capital Structure
for the period ending
September 20, 1994

Industry Averages			as a % of Total Capitalization			After-tax
	Debt/Equity*	Equity/Assets**	Short-Term[2]	Long-Term	Total Debt	ROE
Finance Companies[1]	6.04x	13.47%	33.95%	51.11%	85.06%	16.54%
			Deposits[3]	Borrowings[4]	Dep.+Borrow.	
Money Center Banks	11.83x	6.59%	57.97%	34.12%	92.09%	15.89%
Regional Banks	11.66x	7.84%	73.58%	18.41%	91.98%	16.10%
All Banks	11.68x	7.68%	71.49%	20.50%	92.00%	16.07%

				as a % of Total Capitalization		
Finance Companies	Mix	Debt/Equity	Equity/Assets	Short-Term[2]	Long-Term	Total Debt
1 American General Finance Corporation	Consumer	5.05x	15.18%	28.53%	54.95%	83.48%
2 Aristar, Inc.	Consumer	3.09x	22.82%	12.41%	63.14%	75.55%
3 Associates Corporation of N.A.	Diversified	7.05x	11.89%	38.86%	48.72%	87.58%
4 Avco Financial Services, Inc.	Consumer	5.96x	13.27%	33.11%	52.53%	85.64%
5 Beneficial Corporation	Consumer	7.46x	10.48%	30.79%	57.38%	88.18%
6 CIT Group Holdings, Inc.	Commercial	6.63x	11.45%	48.47%	38.43%	86.90%
7 Commercial Credit Company	Consumer	5.86x	12.10%	33.76%	51.66%	85.42%
8 FINOVA Capital Corporation	Commercial	5.44x	14.09%	31.52%	52.96%	84.47%
9 General Electric Capital Corporation[1]	Diversified	8.07x	8.47%	#N/A	#N/A	#N/A
10 Heller Financial, Inc.	Commercial	5.00x	15.04%	32.25%	51.09%	83.34%
11 Household International	Diversified	9.76x	7.02%	51.19%	39.51%	90.70%
12 Norwest Financial, Inc.	Consumer	5.98x	13.38%	28.21%	57.46%	85.67%
13 Transamerica Finance Group, Inc.	Diversified	5.17x	14.89%	38.33%	45.48%	83.80%

Source: SEC Filings

Finance Company Average[1]	6.04x	13.47%	33.95%	51.11%	85.06%

Footnotes:
(1) Averages do not include GECC, as only limited information is provided on a quarterly basis.
(2) Finance company short-term debt consists primarily of commercial paper.
(3) Bank deposits consist of all deposits.
(4) Borrowings consist of both short-term and long-term borrowings.

* Total liabilities divided by total shareholders' equity -- shows to what extent owners equity can cushion creditors' claims.
** Equity ratio -- measures the proportion of total assets financed by stockholders, as distinguished from creditors.

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization: Deposits[3]	Borrowings[4]	Dep. + Borrow.
1. AmSouth Bancorporation	Regional	11.70x	7.82%	75.31%	16.82%	92.12%
2. Bank One Corporation	Regional	10.19x	8.81%	75.90%	15.16%	91.06%
3. Bancorp Hawaii, Inc.	Regional	11.51x	7.78%	56.92%	35.09%	92.01%
4. Bank of Boston Corporation	Regional	12.76x	7.03%	70.76%	21.90%	92.73%
5. Bank of New York Company	Money Center	10.30x	8.39%	71.85%	19.30%	91.15%
6. Bank South Corporation	Regional	10.23x	8.75%	69.73%	21.37%	91.10%
7. Bank America Corporation	Regional	9.54x	8.84%	76.54%	13.97%	90.51%
8. Bankers Trust New York Corp.	Money Center	15.74x	4.40%	28.17%	65.86%	94.03%
9. BanPonce Corporation	Regional	11.39x	7.95%	72.45%	19.48%	91.93%
10. Barnett Banks, Inc.	Regional	11.56x	7.86%	82.20%	9.83%	92.04%
11. BB&T Financial Corporation	Regional	11.17x	8.12%	74.42%	17.37%	91.79%
12. Boatmen's Bancshares, Inc.	Regional	11.67x	7.80%	73.24%	18.87%	92.11%
13. Central Fidelity Banks, Inc.	Regional	13.82x	6.64%	73.18%	20.87%	93.25%
14. Centura Banks, Inc.	Regional	11.76x	7.74%	84.17%	7.99%	92.16%
15. Chase Manhattan Corporation	Money Center	10.77x	7.21%	69.39%	22.11%	91.50%
16. Chemical Banking Corp.	Money Center	12.58x	6.38%	63.34%	29.29%	92.64%
17. Citicorp	Money Center	11.40x	6.70%	73.39%	18.54%	91.94%
18. Comerica Incorporated	Regional	12.20x	7.50%	64.53%	27.90%	92.43%
19. Compass Bancshares, Inc.	Regional	12.77x	6.94%	75.22%	17.52%	92.74%
20. CoreStates Financial Corp.	Regional	10.65x	8.14%	76.11%	15.31%	91.42%
21. Crestar Financial Corporation	Regional	11.74x	7.73%	77.22%	14.93%	92.15%
22. Fifth Third Bancorp	Regional	9.26x	9.53%	76.14%	14.11%	90.25%
23. First Bank System, Inc.	Regional	10.03x	8.81%	73.44%	17.50%	90.94%
24. First Chicago Corporation	Money Center	11.74x	6.91%	51.29%	40.86%	92.15%
25. First Empire State Corporation	Regional	13.16x	7.00%	72.12%	20.82%	92.94%
26. First Fidelity Bancorporation	Regional	10.64x	8.38%	82.30%	9.11%	91.41%
27. First Hawaiian, Inc.	Regional	10.17x	8.73%	72.02%	19.02%	91.05%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation.

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization: Deposits[1]	Borrowings[4]	Dep. + Borrow.
28. First Interstate Bancorp	Regional	14.01x	6.55%	90.21%	3.13%	93.34%
29. First of America Bank Corp.	Regional	14.57x	6.37%	83.81%	9.77%	93.58%
30. First Security Corporation	Regional	11.87x	7.64%	69.54%	22.70%	92.23%
31. First Tennessee National Corp.	Regional	12.41x	7.20%	75.29%	17.26%	92.54%
32. First Union Corporation	Regional	11.91x	7.57%	73.98%	18.27%	92.25%
33. Firstar Corporation	Regional	10.35x	8.66%	75.59%	15.60%	91.19%
34. Fleet Financial Group	Regional	12.22x	7.33%	73.76%	18.68%	92.44%
35. Huntington Bancshares Inc.	Regional	10.95x	8.25%	69.25%	22.38%	91.63%
36. Integra Financial Corp.	Regional	13.71x	6.71%	73.20%	20.01%	93.20%
37. J.P. Morgan & Co. Incorporated	Money Center	10.23x	6.29%	41.70%	49.40%	91.09%
38. KeyCorp	Regional	12.48x	7.29%	75.44%	17.14%	92.58%
39. Mellon Bank Corporation	Regional	7.75x	10.92%	72.34%	16.23%	88.57%
40. Meridian Bancorp, Inc.	Regional	10.82x	8.33%	77.69%	13.85%	91.54%
41. Midlantic Corporation	Regional	9.04x	9.84%	82.98%	7.06%	90.04%
42. National City Corporation	Regional	10.56x	8.49%	75.06%	16.30%	91.35%
43. NationsBank Corporation	Regional	14.58x	6.27%	57.99%	35.59%	93.58%
44. NBD Bancorp, Inc.	Regional	12.71x	7.14%	68.36%	24.35%	92.71%
45. Northern Trust Corporation	Regional	13.37x	6.75%	62.21%	30.83%	93.04%
46. Norwest Corporation	Regional	13.12x	6.76%	64.34%	28.58%	92.92%
47. Old Kent Financial Corporation	Regional	11.16x	8.13%	82.91%	8.87%	91.78%
48. PNC Bank Corp.	Regional	13.00x	6.95%	53.94%	38.91%	92.86%
49. Provident Bancorp, Inc.	Regional	13.44x	6.83%	71.23%	21.85%	93.08%
50. Regions Financial Corp.	Regional	11.78x	7.73%	80.48%	11.69%	92.17%
51. Republic New York Corporation	Money Center	11.88x	6.48%	64.65%	27.58%	92.24%
52. Shawmut National Corporation	Regional	13.54x	6.79%	63.06%	30.06%	93.12%
53. Signet Banking Corporation	Regional	8.95x	9.81%	70.96%	18.99%	89.95%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization: Deposits[1]	Borrowings[4]	Dep. + Borrow.
54. SouthTrust Corporation	Regional	13.82x	6.66%	73.18%	20.07%	93.25%
55. Star Banc Corp.	Regional	12.01x	7.62%	77.98%	14.33%	92.31%
56. Sun Trust Banks, Inc.	Regional	10.50x	8.47%	80.29%	11.01%	91.31%
57. Synovus Financial Corp.	Regional	10.62x	8.45%	85.58%	5.81%	91.39%
58. U.S. Bancorp	Regional	10.75x	8.25%	72.95%	18.54%	91.49%
59. Wachovia Corporation	Regional	10.51x	8.43%	60.13%	31.19%	91.31%
60. Wells Fargo & Company	Regional	11.71x	7.71%	78.23%	13.90%	92.13%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation.

Bank Averages	Debt/Equity	Equity/Assets	Deposits	Borrowings	Dep. + Borrow.
Money Center Banks	11.83x	6.59%	57.97%	34.12%	92.09%
Regional Banks	11.66x	7.84%	73.58%	18.41%	91.90%
All Banks	11.68x	7.68%	71.49%	20.50%	92.00%

By assigning the credit ratings, the rating agencies in effect set capital adequacy guidelines for finance companies. In these guidelines, the agencies take important account of the parents' strength and the financial ties between parents and subsidiaries. When the parent is rated higher than the finance company, rating agencies look for mechanisms that protect the subsidiary in the event of parent stress. These mechanisms may include attorney's letters and debt covenants limiting the capital a parent may take out of a subsidiary. On average, a subsidiary receives a somewhat higher rating than its parent because the financial ties are designed to enhance the finance company's rating rather than its parent's.

IMPLICATIONS OF MARKET REGULATION FOR FINANCIAL MODERNIZATION

As is demonstrated by the above, it is the sensitivity to the financial condition of both the parent and financial subsidiary combined with the ability of the market to act quickly, without discretion, that makes market regulation so effective and gives lie to so many of the doomsday scenarios when an insured institution is thrown into the mix. In the structure proposed in H.R. 814, with separately capitalized affiliates, most of whom are market regulated, it is difficult to see the risk to the insured institution, especially when combined with the bill's "capital bear down" provisions. The rating agencies and markets are going to be well aware of the liability of the holding company and its uninsured affiliates to the insured institution; this will be reflected in the capital ratios and debt ratings for the market funded firms in the holding company and the reaction of the market to any problems in any of the affiliates, particularly the insured affiliate as the market will know that the liability to the insured affiliate is virtually unlimited while the liability of the insured affiliate to the others is nonexistent.

Quoting again from the 1988 Committee on Government Operations report , *Modernization of the Financial Services Industry: A Plan For Capital Mobility Within A Framework of Safe and Sound Banking*:

"The present U.S. banking system is not only strictly regulated as to how it conducts its basic banking business but also, in theory, it is tightly compartmentalized from other types of financial and nonfinancial business. The principal objective of this structure of intense regulation and tight compartmentalization that has evolved over the years has been to control the risk exposure of individual banks so as to protect their safety and soundness and, thereby to maximize the stability of the banking and financial system as whole.

The stability of the financial system is also based fundamentally on the Government-sponsored deposit insurance protection provided for for bank and other depository institution deposits... This system of deposit insurance then provides a further reason to impose regulatory barriers and tight risk standards on banks and other depository institutions, in order to protect the insurance funds from losses. .... almost no corporations other than existing banks or bank holding companies are permitted to purchase a bank or start a new bank. Existing banks as a group, are thus protected from new competition from other business corporations. This comprehensive barrier against corporate entry into banking also serves to reduce the risks in banking by screening out potential competition."

(H.R. REP. No. 100-324., 100th Congress, 1st Sess., 3-4. (1987)).

Obviously, this has not worked very well compared to market regulation and competition. The goal of any financial modernization should be to reduce the dependence on deposit insurance and government regulation with the substitution of market discipline. To the extent that certain functions must be conducted in insured institutions, ownership of these institutions should not be restricted.

The other reason deposit insurance must be substantially addressed is because it has provided the nexus for a whole host of regulation that has nothing to do with safety and soundness, but instead is designed to fund a host of social programs. As budget funds for new programs are very scarce and almost no old programs are cut, many interest groups are searching for private income streams that can be nationalized for social purposes. Deposit insurance has provided the basis for all of these. It is important to take advantage of the opportunity the Committee has before it to reduce to the maximum extent this exposure.

CONCLUSION

H.R. 1062, as indicated above, takes a full step forward in modernizing our financial system and should be applauded. As the above testimony indicates, there are many competitive and structural issues that are not addressed by H.R. 1062. At the present time, AFSA feels that H.R.814 provides a better basis for placing all issues on the table and moving forward with comprehensive modernization. We hope that the committee will examine all of these issues in the hearing process before deciding to move forward.

A P P E N D I X

March 15, 1995

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"
AND RELATED ISSUES

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

MARCH 15, 1995

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

**TESTIMONY OF
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MARCH 15, 1995

Chairman Leach and Members of the Committee:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding H.R. 18, the "Financial Services Competitiveness Act of 1995," introduced earlier this year by Chairman Leach.[1] I would like to thank you, Mr. Chairman, for holding these hearings and initiating the present dialogue on Glass-Steagall reform and financial services modernization.

The Commission supports the principal purpose of H.R. 18, which is to permit banks to participate more fully in the securities business through affiliated companies. Glass-Steagall reform would provide banks with greater flexibility and new avenues for innovation. By bringing new bank competition to the market for securities services and products, Glass-Steagall reform could also benefit consumers and the financial markets as a whole. The Commission would welcome these developments.

Much of the debate on Glass-Steagall reform and financial services modernization to date has focused on these bank-related issues. This is understandable. The special role of banks in

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1 H.R. 18 was revised and reintroduced as H.R. 1062 on February 27, 1995. We refer to the revised bill as H.R. 18 for the purpose of this testimony.

the U.S. economy, the important safety and soundness issues linked to the solvency of the federal deposit insurance safety net, and the competitive benefits Glass-Steagall reform will bring to the banking industry, are all important issues that deserve serious consideration.

As Congress considers how, and to what extent, to permit affiliations between the banking and securities industry, it is important also to remember that Congress' actions in this area will likely have a profound effect on investors and the securities markets generally, as well as banks. As the debate on Glass-Steagall reform moves forward, the Commission urges the Committee to keep in mind two important principles:

First, the investors' perspective must be maintained. Investors benefit from a wide array of financial products and providers. Investors benefit more when they can be assured of the integrity of markets and when they can be assured they will receive a high level of investor protection. The Commission therefore urges Congress to make investor protection as much of a priority as bank safety and soundness.

Second, the vitality of our capital markets must be preserved. The U.S. capital markets are the deepest, most liquid, and strongest in the world. In 1994 alone these markets raised $1 trillion in capital for companies, to support new industries and create new jobs. This capital was raised directly from private investors, without the benefit of federal deposit insurance. As Congress weighs expanding bank securities powers, it must be careful not to impose bank-style "safety and soundness" requirements or constraints on the securities markets that could impair their continued success.

The Commission is pleased that H.R. 18 takes steps to address these issues. Specifically, the bill contains provisions that would enhance investor protection by promoting

functional regulation of bank securities activities. The Commission strongly supports the principle of functional regulation; we have long maintained that Glass-Steagall reform must be accompanied by reforms to bring bank securities activities within the securities regulatory scheme. Such an approach would ensure that the securities and banking activities of all market participants -- regardless of the structure in which they are conducted -- would be subject to a single set of standards, consistently applied by one expert regulator.

In addition, H.R. 18 contains important provisions that would facilitate regulatory coordination and information-sharing. These provisions recognize and build on the concept of functional regulation, and are intended to promote efficient regulation that does not unduly burden the operation of our capital markets.

The Commission strongly supports the thrust of these provisions. However, we believe that additional attention to these areas is warranted. In particular, the Commission has concerns regarding the numerous exceptions in H.R. 18's functional regulation provisions, which would allow banks to engage in significant securities activities outside the securities regulatory scheme. Likewise, more can be done to clarify and strengthen the provisions aimed at achieving what FDIC Chairman Ricki Tigert Helfer described as "seamless" regulatory co-ordination.[2]

The Commission fully appreciates the difficulty of the Committee's task. In reforming Glass-Steagall, the goals of safeguarding bank safety and soundness and maintaining a fair and competitive securities market must be harmonized. The Commission is convinced that adoption of a strong system of functional regulation will make it easier to strike the appropriate balance.

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[2] Testimony of Ricki Tigert Helfer, Chairman, Federal Deposit Insurance Corporation ("FDIC"), on the "Financial Services Competitiveness Act of 1995" and Related Issues Before the House Committee on Banking and Financial Services, Feb. 28, 1995, at 11.

Finally, the Commission recognizes that Glass-Steagall reform raises many other complex, related questions, such as how to provide a "two-way street" for securities firms that wish to acquire banks. The Commission believes that in order to preserve the vitality and fairness of our markets, financial reform must provide equal opportunities for all market participants. The Commission is pleased to assist the Committee as it considers this and other important issues, and looks forward to working with the Committee toward our shared goals.

The remainder of this statement provides background information on the existing regulatory structure for bank securities activities and discusses functional regulation, the "two-way street," and related issues. More detailed comments on the securities-related provisions contained in H.R. 18 are set forth in the appendix to this testimony.

I. The Existing Regulatory Structure and the Need for Regulatory Reform

A. Background and recent market developments

Before enactment of the Glass-Steagall Act, some sixty years ago, U.S. banks were significant participants in the nation's capital markets. Indeed, by 1930, bank affiliates were sponsoring over 50 percent of all new securities issues, and 41 percent of all commercial bank assets were invested in securities or securities-related loans.[3]

Bank involvement in the securities markets came under close scrutiny after the 1929 market crash. The Pecora hearings of 1933, which focused on the causes of the crash and the subsequent banking crisis, uncovered a wide range of abusive practices on the part of banks and

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[3] See Susan E. Kennedy, The Banking Crisis of 1933 212 (1973); Donald Langevoort, Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation, 85 Mich. L. Rev. 672, 694 (1987). Banks and bank affiliates by 1930 also claimed a 61 percent market share of new bond issue participations. See Edwin Perkins, The Divorce of Commercial and Investment Banking, 88 Banking L. J. 483, 495, 527 (1971).

bank affiliates. These included a variety of conflicts of interest;[4] the underwriting of unsound securities in order to pay off bad bank loans; and "pool operations" to support the price of bank stocks.

Revelations about these and other abuses reinforced concerns about the role that banks had played in the speculative fever of the 1920s. The hearing record also compounded fears that the securities activities of bank affiliates threatened bank safety and soundness. Ultimately, strong public reaction to the hearings prompted the enactment of the Glass-Steagall Act and the separation of commercial from investment banking.[5] At the same time, banks were excluded from the regulatory scheme enacted for securities brokers and dealers, based in large part on the assumption that the Glass-Steagall Act barred banks from engaging in most securities activities.[6]

Much has changed in the six decades that have passed since the enactment of the Glass-Steagall Act. Economic expansion, new technologies, and innovative financial products have

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4 Congress was concerned, for example, about the use of bank loans to support bank affiliates and affiliate-underwritten securities, and about bank incentives (in giving investment advice) to promote affiliate-underwritten securities.

5 There is a broad spectrum of views on the degree to which the Glass-Steagall Act actually responded to the causes of the banking crash. See, e.g., ICI v. Camp, 401 U.S. 617 (1971) (Act was intended to protect bank safety and soundness by preventing abuses of securities affiliates); Langevoort, supra note 3 (Act reflects then-orthodox banking theory that banks should concentrate on commercial lending, combined with a need to respond to the public outcry that followed the Pecora hearings); William Isaac and Melanie Fein, Facing the Future -- Life Without Glass-Steagall, 37 Cath. U. L. Rev. 281 (1988) (no link was ever shown between securities activities and collapse of banking system; Act responded to public outcry rather than hard evidence).

6 See Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 86 (Feb. 16, 1934) (statement of Thomas G. Corcoran, an administration spokesman and a principal drafter of the Securities Exchange Act of 1934). Later, the Investment Advisers Act of 1940 also excluded banks and bank holding companies from regulation as investment advisers.

resulted in the striking growth of the U.S. capital markets. The $1 trillion raised in the U.S. capital markets in 1994 represents more than a 1500-fold increase over the $641 million raised in 1934. Regulatory changes, meanwhile, have allowed banks to play an ever-larger part in those capital markets. Over the last two decades, through expansive banking agency interpretations, banks have gained entry into a wide range of securities activities that were once thought to be foreclosed by the Glass-Steagall Act.[7] To offer just a few examples:

- in 1994, 119 banks provided investment advice or other services to over $312 billion in mutual fund assets (representing approximately 15% of total mutual fund assets);[8]
- in 1994, over 1800 banking firms sold mutual funds to their customers;[9]
- as of January 1995, the Federal Reserve had authorized 36 bank holding companies to operate so-called "Section 20" underwriting affiliates;[10]
- in the third quarter of 1994, the assets of Section 20 affiliates accounted for 16.6% of the assets of all broker-dealers doing a public business.[11]

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[7] At the same time, securities firms have entered into some aspects of the banking business. For example, recent reports state that Goldman, Sachs & Co. will join with four commercial banks in underwriting a $1.5 billion bank loan in connection with the acquisition of Santa Fe Pacific Corp. by Burlington Northern Inc. See S. Lipin, Goldman Sachs, Taking Unusual Role, Joins Bank Loan for Santa Fe Takeover, Wall St. J., Feb. 3, 1995, at A4.

[8] See Lipper Bank-Related Fund Analysis (4th Quarter 1994). Commission records indicate that banks advise approximately 35% of all open-end fund portfolios (total: 4,899) or approximately 8% of all investment company portfolios (total, including closed-end funds and unit investment trusts: 27,764).

[9] See Michelle Clark, Call Reports Show Surprisingly Few Banks Selling Funds, American Banker, Aug. 25, 1994, at 12.

[10] Sixteen of these affiliates had received approval to underwrite both corporate debt and equity issues.

[11] Section 20 affiliates also accounted for 7.7% of the total capital and equity capital, for 12.1% of total revenues, and for 15.6% of total proprietary trading.

The statutory framework for bank securities activities has not evolved to keep pace with the dramatic changes that have taken place in U.S. financial markets in recent years.[12] On the one hand, the Glass-Steagall Act continues to limit the scope of permissible bank activities. On the other hand, the outdated bank exclusions still contained in the federal securities laws allow banks to conduct a wide range of securities activities outside the regulatory scheme established for all other broker-dealers and investment advisers.

Clearly, the time has come to modernize the existing regulatory structure for banks. At the same time, it must be recognized that entry into the securities business involves its own risks.[13] Indeed, risk-taking is fundamental to the securities business.[14] Congress, therefore, in considering Glass-Steagall reform, will have to strike a careful balance between protecting bank safety and soundness and permitting the risk-taking that is central to capital markets activities. Banking regulation has traditionally limited bank risk-taking, in the interests of bank safety and soundness. But securities firms, and the securities markets generally, specialize in

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12 Certain statutory changes have, however, addressed some of the problems identified in the Pecora hearings. For example, Federal Reserve Act sections 23A and 23B limit and set standards for transactions between banks and their affiliates. Moreover, the federal securities laws address the problem of inadequate disclosure, prohibit insider abuses and other forms of securities fraud, and provide for federal market oversight.

13 Lending and other banking activities, of course, also involve risk. See Testimony of FDIC Chairman Tigert, supra note 2, at 3-4.

14 Markets are by nature volatile; they go down as well as up. Thus, while 1993 was generally a profitable year for securities firms, 1994 was labelled "Wall Street's worst business environment in years." Salomon Inc, CS First Boston Co., Goldman Sachs, and J.P. Morgan & Co. (for example) suffered lower earnings or losses and subsequently announced layoffs and other cost-cutting measures. See Red Braces, Pink Slips, The Economist, Feb. 18, 1995, at 73. Only last month J.P. Morgan (the first banking firm approved to engage in corporate debt and equities underwriting through a Section 20 affiliate) lost its long-standing triple-A rating from Moody's Investors Service, Inc., due in large part to concerns regarding J.P. Morgan's move away from commercial banking and into investment banking. See S. Kleege, Moody's Lowers Rating for Morgan, Citing Focus on Investment Banking, Am. Banker, Feb. 15, 1995, at 24.

entrepreneurial and risk-taking activities.[15] Sometimes they misjudge: securities firms may have "bad years" (as in 1994) and may even fail. Nonetheless, it is through taking on market risks that securities firms are able to serve as a powerful engine for U.S. capital formation.

B. Current regulation of bank securities activities

Before turning to a discussion of how the existing regulatory structure should be reformed, it is important to review the current framework for bank securities activities and some of the more significant disparities that exist with respect to bank broker-dealer and investment adviser activities.

Today, banks engage directly[16] in a wide range of broker-dealer and investment advisory activities that are comparable to, and competitive with, the services of registered securities firms and investment advisers. They generally do so, however, outside the regulatory framework established under the federal securities laws.[17]

Banking regulation -- which does apply to bank securities activities -- has not traditionally focused on investor protection and the maintenance of fair and orderly markets.

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15 For this reason, securities regulation does not seek completely to insulate securities firms from the risks they incur in their business activities. Instead, the regulatory framework seeks to protect investors and maintain fair and orderly markets by imposing financial responsibility, training and competency, supervision, disclosure, antifraud and other requirements on securities firms. Within these parameters, risk-taking is largely left to market control, not to governmental management.

16 Banks also may choose to engage in securities activities through a number of indirect routes. For example, a bank may conduct its sales or investment advisory activities through subsidiaries or affiliates registered with the Commission. This section of the Commission's testimony, however, focuses on the direct securities activities of banks. Such activities -- though subject to the antifraud provisions of the federal securities laws -- take place outside the federal regulatory scheme for securities activities.

17 The unique treatment afforded bank securities activities stands in contrast to the regulatory schemes for bank transfer agents and bank municipal and government securities activities, which are regulated under the federal securities laws.

The banking agencies are charged with protecting the viability of banking institutions, as well as the solvency of the federal deposit insurance system. In contrast, the Commission has as its focus disclosure, market discipline, and enforcement, with an overall mandate to protect investors and maintain fair and orderly securities markets. These different philosophical approaches affect the ways in which regulation and enforcement are undertaken.[18]

Bank broker-dealer activities. Banks that engage directly in securities activities are excluded from the definitions of "broker" and "dealer" in the Exchange Act and are therefore exempt from broker-dealer regulation under the federal securities laws. Their activities are subject only to federal banking law and the antifraud provisions of the federal securities laws. Federal banking laws and regulations, however, do not specifically address important aspects of bank brokerage activities.[19] For example:

- Banking regulations do not require banks to register or provide information regarding their securities activities, nor do they impose special financial responsibility requirements as a condition of engaging in direct securities activities.
- Banking regulations do not establish specific qualification and continuing education requirements for bank securities salespersons.
- Federal banking law does not provide for the statutory disqualification of bank securities salespersons with disciplinary histories.
- The federal banking statutes and regulations do not comprehensively address sales practice issues, nor do they impose an explicit duty to supervise bank securities sales personnel.

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[18] For a discussion of the differences in philosophy and specific requirements between banking and securities regulation, see Testimony of Chairman Arthur Levitt Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee Concerning H.R. 3447 and Related Functional Regulation Issues (April 14, 1994) at 2. For a detailed, side-by-side comparison of banking and securities laws and regulations, see Proposed Mellon-Dreyfus Merger: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 103d Cong., 2d Sess. 906-72 (1994).

[19] The federal banking laws do, however, contain limited recordkeeping and confirmation requirements relating to bank securities transactions. See, e.g., 12 C.F.R. §§ 12.1-12.7, 12 C.F.R. §§ 344.1-344.7, and 12 C.F.R. § 208.8(k).

- **Finally, bank securities customers have no formal avenue of redress for complaints, and the federal banking laws do not generally contain private rights of action for investors.[20]**

Over the last two years, the federal banking agencies have issued guidelines and a subsequent Interagency Statement[21] designed to supplement their securities regulatory programs. While these guidelines represent an important forward step, they do not create a comprehensive securities regulatory scheme for banks. As "guidelines" rather than regulations, they are advisory rather than legally binding, and may not be legally enforceable by the bank regulators or by bank customers. Furthermore, the guidelines do not establish precise standards of conduct; banks are given wide latitude to establish procedures and policies to implement them.

The guidelines, moreover, raise potential problems of regulatory overlap insofar as they apply to registered broker-dealers that are affiliated or have contracts with banks for the sale of securities.[22] Since broker-dealers are already subject to comprehensive Commission and self-regulatory organization ("SRO") regulation under the federal securities laws, imposing an additional layer of banking regulator oversight and examinations is unnecessary.

Bank investment adviser activities. A separate set of problems exists with respect to the regulation of banks that advise registered investment companies ("funds"). Banks are excluded from Commission oversight under the Advisers Act (although bank advisory relationships with funds are subject to the Investment Company Act of 1940). Because bank advisers are not required to register with the Commission as investment advisers, Commission examiners may

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[20] See, e.g., In re Fidelity Bank Trust Fee Litigation, 839 F. Supp. 318 (E.D. Pa. 1993); In re Corestates Trust Fee Litigation, 837 F. Supp. 104 (E.D. Pa. 1993).

[21] See Board of Governors of the Federal Reserve System ("Federal Reserve Board"), FDIC, OCC, and Office of Thrift Supervision, "Interagency Statement on Retail Sales of Nondeposit Investment Products" (Feb. 15, 1994) (the "Interagency Statement").

[22] The OCC, for example, has recently begun to examine registered broker-dealers that sell securities in association with national banks.

not have access to all the books and records normally available when the adviser is registered.[23] In addition, banks are not subject to a number of substantive requirements applicable to other investment advisers, including regulation of performance fees, procedures to prevent misuse of non-public information, and the Advisers Act anti-fraud provisions.

In other respects, bank-advised funds (like bank-affiliated broker-dealers) face the problem of overlapping regulation. Some of the banking agencies have recently indicated that they may expand their role to include oversight of funds advised by banks.[24] This move is likely to create new problems in the form of duplicative and potentially conflicting regulation, as bank-advised funds become subject to multiple regulators. As one commentator has noted, "we are heading toward a world of five federal mutual fund regulators -- the SEC and the four federal banking agencies."[25]

II. The Case for Functional Regulation

The existing regulatory framework for bank securities activities -- containing both gaps and redundancies -- plainly needs to be restructured. Investor protection must be made a priority, and the regulatory system must be made more efficient and more rational. The adoption of functional regulation, in our view, is necessary to achieve the following important objectives:

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[23] Commission records indicate that approximately 61% of bank-affiliated investment companies are managed by investment advisers not subject to full Commission oversight.

[24] See, e.g., S. Prakash, "Comptroller Drafts Guidelines for Mutual Fund Activities." American Banker, July 1, 1994, at 12.

[25] M. Fink, "SEC Needs a Strong Hand in Regulating Funds," American Banker, March 31, 1994, at 13.

Investor protection. Functional regulation of bank securities activities would further investor protection by subjecting all securities activities to a single set of standards, consistently applied by one expert regulator -- in marked contrast to the fragmented system currently in place. Banks and broker-dealers alike would be subject to the same requirements with respect to training, supervision, sales practices, financial responsibility, and other important matters. Banks that advise investment companies, like all other registered investment advisers, would be fully subject to oversight and other requirements designed to guard against conflicts of interest. The Commission strongly believes that Congress should make these changes to close existing gaps in investor protection, whether or not broader Glass-Steagall reform is adopted.

Elimination of duplicative regulation. Under existing law, bank-affiliated securities firms and investment companies must comply with overlapping and potentially inconsistent regulatory requirements. This duplication confuses the industry, imposes unnecessary costs, impairs industry competitiveness, and wastes scarce government resources. Replacement of the existing regulatory scheme with a system of functional regulation should relieve financial services providers (and the markets as a whole) from many of the burdens of duplicative regulation. Of course, with financial services reform and the expansion of bank securities activities, there will be an ever-greater need for cooperation among regulators.[26]

III. Two-Way Street and Other Issues

In addition to the issue of functional regulation, Glass-Steagall reform must address the need to provide for a meaningful "two-way street," whether to retain some form of consolidated

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[26] The Commission and its banking agency counterparts have already taken a number of steps toward improved regulatory coordination. For instance, Commission and OCC staff have held discussions on the subjects of (1) joint inspections of banks and their affiliated mutual funds, and (2) coordination of enforcement actions. The Commission is optimistic that this and similar initiatives will result in better working relationships. However, these steps will not correct the underlying flaws in the existing regulatory structure.

regulation at the holding company level, and whether to relax the strict separation of banking and commerce. These are admittedly difficult issues. The Commission would like to take this opportunity to add its views to the current debate on this subject, as well as on related issues involving the structure of bank affiliations with securities firms.

Subsidiaries vs. affiliates. A threshold matter that is the subject of current debate is how bank affiliations with securities firms should be structured. Some have argued that banks should be free to choose between a subsidiary and a bank holding company affiliate structure. Others believe that banks, and ultimately the bank insurance fund, would be better protected if their securities activities were undertaken in bank holding company affiliates rather than bank subsidiaries. From a functional regulation perspective, use of either structure is preferable to directly conducting securities activities in a bank.

The Commission does, however, prefer the affiliate structure.[27] In our view, it offers a greater separation and creates sharper distinctions between the bank and any related securities firm.[28] A clear separation between banking and securities functions guards against confusion, and makes it easier to build and enforce strong firewalls. Use of affiliates rather than subsidiaries also serves to limit the potential for conflicts of interest, such as abusive affiliate

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[27] In this regard, Commissioner Wallman believes that the Commission should have no preference as to whether the appropriate structure should be a subsidiary, affiliate, or some other structure. Federal regulatory agencies should apply the same set of rules to the same activity engaged in by any entity regardless of its particular form.

Thus, in his view, if Congress 1) limited overlapping regulation by the banking and securities regulators and 2) ensured through a system of strong functional regulation that the Commission had appropriate authority to regulate the securities activities engaged in by banks and their related entities, the form of entity -- provided it was separate from the bank -- should be irrelevant to the Commission.

[28] See Commission Testimony Concerning S. 543 and S. 713 Before the Senate Committee on Banking, Housing and Urban Affairs, May 7, 1991, at 22.

transactions.[29] Finally, the Commission generally has had a positive experience regulating Section 20 broker-dealer affiliates in the context of a larger holding company structure.

"Two-way street." Nevertheless, as a general matter, the Commission believes that for financial modernization reform to be truly effective, it must allow for vigorous competition between all market participants. A meaningful "two-way" street must provide equal opportunities for market participation to banks and securities firms alike. Competition, moreover, should occur on the basis of market performance, not differential regulation.

Within the context of the existing regulatory structure, repeal of the Glass-Steagall Act would allow banking organizations to acquire securities firms, but would not necessarily enable securities firms to acquire banks. A securities firm that sought to acquire even a small bank would have to submit to comprehensive regulation by the Federal Reserve as a holding company. Accordingly, those securities firms that could acquire banks (i.e., those unaffiliated with commercial entities) would have to accept a radical change in their regulatory supervision in order to do so. At a minimum, this would result in significant new regulatory costs.

In expanding bank securities powers, Congress therefore needs to decide how to give securities firms a meaningful opportunity to enter into the banking business. This requires a more focused approach to bank safety and soundness than bringing all affiliates within the existing framework of consolidated bank-style regulation.

Consolidated "umbrella" regulation. The term "umbrella" regulation refers to the type of consolidated holding company regulation that currently exists under the Bank Holding

[29] For example, at present, transactions between a bank and its affiliates are subject to restrictions contained in Sections 23A and 23B of the Federal Reserve Act; transactions between a bank and its subsidiaries, however, are not governed by those restrictions.

Company Act. Among other things, that model requires regulatory approvals before affiliates may enter a new line of business, as well as comprehensive supervision of the holding company and all of its affiliates.

The Commission recognizes that bank affiliations with securities firms may raise bank safety and soundness issues (and, ultimately, issues related to protection of the deposit insurance fund). However, it would be misguided to seek to control these risks by imposing an overlay of bank-type "safety and soundness" regulation on nonbank affiliates -- as consolidated bank holding company regulation currently does. In particular, this approach is not well-suited for companies that seek to compete vigorously in new lines of business and fast-moving markets.

In lieu of consolidated holding company regulation, the Commission would prefer an approach based on strong functional regulation, effective firewalls, and enhanced regulatory coordination.

Under this approach, each entity in the holding company complex would be separately regulated by its expert regulator in accordance with the principle of functional regulation. The federal banking regulators (consistent with their special expertise) would be charged with containing any potential risks to bank safety and soundness that arise as a result of bank affiliations with other entities. The Commission and the SROs, consistent with our statutory mandate and particular expertise, would enforce investor protection and provide market oversight. In this manner, duplicative and potentially inconsistent regulation could be avoided.

In order to address issues of systemic risk, the functional regulator should be able to receive information concerning the activities and exposures of affiliates. This would enable the

functional regulator to monitor the risks to which the regulated entity is exposed.[30] Thus, a bank regulator would have access to "risk-assessment" information about a securities affiliate or an information technology affiliate.[31]

Firewalls. The Commission believes that Congress' efforts to protect bank safety and soundness should pay particular attention to the creation of appropriate "firewalls" designed to insulate banks from the risk of their securities affiliates. Although opinions differ regarding the details of the specific firewalls, and whether they should be statutory or discretionary in nature, the Commission believes that most of the parties to the Glass-Steagall debate acknowledge the importance of "firewalls" to protect the banking system and the solvency of the federal deposit insurance system in the context of Glass-Steagall repeal. To the extent that such firewalls are predicated on bank safety and soundness concerns, the Commission generally defers to Congress and the banking regulators.

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30 A model for such a system already exists in the federal securities laws. Pursuant to the Market Reform Act of 1990, the Commission adopted rules establishing a risk assessment program that requires broker-dealers to file quarterly reports on their affiliates within a holding company group whose business activities are reasonably likely to have a material impact on the financial and operational condition of the broker-dealer. Under the Commission's risk assessment rules, the Commission receives essentially the same information that an affiliated bank holding company of a registered broker-dealer is required to file with the Federal Reserve Board. We view the information gathered under the risk assessment program as a significant complement to the Commission's existing broker-dealer authority.

31 Another approach that merits consideration would build on the concept of a "broker-dealer holding company." Under this approach, the Commission would serve as the holding company regulator for firms whose aggregate revenues come primarily from the activities of securities subsidiaries -- even if those firms also control banks. The Commission's regulatory focus would be different from that of the Federal Reserve: the Commission would regulate the broker-dealer holding company according to a risk-assessment approach based on the securities regulatory scheme. A more detailed discussion of this model is set forth in Commission testimony Concerning Financial Services Modernization Before the Senate Committee on Banking, Housing and Urban Affairs, July 19, 1990.

Firewalls addressing conflicts of interest and other matters are also important and should be imposed and enforced by securities, as well as banking, regulators.[32] For example, firewalls aimed at protecting broker-dealer capital would help ensure that bank-affiliated broker-dealers can meet their financial responsibility to customers. Other firewalls could protect investors against underwriting abuses, such as the use of underwriting proceeds to pay off bank loans. Conflicts of interest between banks and the investment companies they advise deserve particular mention. The Investment Company Act and the Advisers Act address conflicts that can arise when brokerage firms or their affiliates conduct investment company activities; but because the current role of banks in the investment company business was not contemplated when those Acts were adopted, new provisions are needed to address the conflicts that can arise between banks and affiliated investment companies.

The Commission is aware of the current debate regarding firewalls, and their potential effects on "synergies" between banks and their affiliates. Without addressing this issue directly, we would simply note that the firewalls contained in the Federal Reserve's Section 20 orders do not appear to have kept Section 20 securities affiliates from competing successfully in the marketplace for securities services.[33]

Commerce and banking. The issue of commerce and banking directly affects the viability of any "two-way street" proposal. Broker-dealers often are affiliated with insurance companies, and they may also hold equity investments in commercial firms as a result of

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[32] In addition, we believe Congress should give consideration to maintaining existing prohibitions on inappropriate tying arrangements.

[33] See figures cited supra at 6 and fn. 11.

merchant banking activities. These firms would be unable to take advantage of any "two-way street" if divestiture of such investments is required.[34]

The Commission appreciates that this is a difficult issue from the banking perspective. Viewed from the securities perspective, however, the Commission has no objections to allowing commercial entities to engage in the securities business. The Commission has had considerable experience recently with the involvement of commercial entities in the securities business, and it has not been problematic for us. The Commission's ability to oversee the registered broker-dealers involved was not impaired and, from time to time, the commercial parents provided a ready source of capital to their affiliated broker-dealers.[35]

IV. H.R. 18

H.R. 18 represents a significant contribution to the debate on Glass-Steagall reform and efforts to modernize our financial services regulatory structure. H.R. 18 would amend the Glass-Steagall Act to allow affiliations between banks and securities firms, through a bank holding company structure and subject to "firewalls" intended to protect bank safety and soundness. There affiliated securities firms would have to be separately incorporated and capitalized. The principle of functional regulation would apply to these affiliates: they would

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34 One possible approach to this problem would be to alter (rather than remove completely) the separation between commerce and banking, so as to allow combinations of banking, insurance, and other financial activities. Under such an approach, it would also be appropriate to provide for regulatory coordination (along the lines discussed above) among banking, securities, and insurance regulators.

35 For example, prior to its recent sale to Paine Webber, Kidder Peabody, a former registered broker-dealer, was controlled by General Electric. General Electric was instrumental in infusing capital at critical points. Similarly, Prudential Insurance Company of America was an additional source of funding for its securities affiliate, Prudential Securities, Inc.

be registered with, and regulated by, the Commission just like any other registered broker-dealer.[36]

H.R. 18 would make many other useful changes in the regulatory framework for bank securities activities. It would further the principle of functional regulation by repealing the blanket exclusion of banks from the definitions of "broker," "dealer," and "investment adviser" under the federal securities laws. It would amend various provisions of the Investment Company Act to take account of growing bank involvement in the fund business. The bill would also amend the Exchange Act to eliminate outdated restrictions on broker-dealer borrowing. Finally, H.R. 18 contains "two-way street" provisions designed to allow securities firms to acquire banks, as well as provisions permitting banks to acquire securities firms.

The Commission supports many of the provisions contained in H.R. 18. We do, however, have three broad concerns about the bill. First, we believe investor protection may be undermined by the bill's provisions granting banks extensive exemptions from broker-dealer regulation. Second, we believe that more can and should be done to eliminate regulatory overlap (and potential regulatory conflict) in the oversight and examination of bank-affiliated securities activities. Third, we believe greater attention must be given to creating a regulatory structure that will permit the establishment of a meaningful "two-way street."

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[36] H.R. 18 thus essentially ratifies the approach the Federal Reserve has followed since 1987 in approving limited underwriting activities for "Section 20" affiliates of bank holding companies.

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A. Bank broker-dealer activities

H.R. 18 would move toward functional regulation of securities activities by requiring that certain bank securities activities be conducted in a broker-dealer separate from the bank, and by partially removing the exclusion of banks from the definitions of broker and dealer contained in the federal securities laws. This bank exclusion, as explained above, is a historical vestige from an era when banks were largely precluded from the securities business.

The Commission strongly supports removal of the bank exclusion from the broker and dealer definitions. Removal of this exclusion would create a "level playing field" for all market participants, and would ensure that the securities regulatory scheme is consistently applied to all securities transactions, irrespective of how an entity is chartered. The Commission, however, has both general and specific concerns about the thirteen new exemptions that H.R. 18 would create for bank brokerage activities.[37]

[37] The bill's thirteen limited exemptions from the definition of "broker" and four limited exemptions from the definition of "dealer" would permit banks to engage in many securities-related activities without being subject to securities regulation. Exemptions from the definition of "broker" are provided for: (i) banks that engage in brokerage activities in connection with "networking arrangements," (ii) certain trust activities, (iii) transactions in exempted and similar securities, including government securities, (iv) transactions in municipal securities, (v) transactions in connection with employee benefit plans, (vi) "sweep" transactions, (vii) affiliate transactions, (viii) private placements, (ix) a de minimis number of transactions, (x) safekeeping and custody services, (xi) clearance and settlement activities, (xii) securities lending, and (xiii) agency transactions involving repurchase agreements. Exemptions from the definition of "dealer" are provided for: banks that engage in transactions involving (i) exempted and similar securities, (ii) municipal securities, (iii) bank and trust department transactions for investment purposes, and (iv) (under limited circumstances) certain categories of asset-backed securities. As discussed in the testimony, the Commission is concerned that these exemptions may create an incentive for securities firms to transfer some of these activities to a bank and away from Commission oversight.

While the Commission does not necessarily object to the specific aims of some of H.R. 18's exemptions,[38] the inclusion of the numerous exemptions serves to undermine the principle of functional regulation that H.R. 18 otherwise seeks to promote. These exemptions would continue to split the regulation of functionally equivalent brokerage and dealer activities between the Commission and the bank regulators, and would permit banks to conduct a significant volume of securities business outside the regulatory framework established under the federal securities laws. As a result, investors who buy securities through their banks would continue to receive a different standard of protection than other investors. In addition, the Commission is concerned that, as securities firms affiliate with banks, securities activities could "migrate" out of securities firms and into affiliated banks, thereby weakening the protections currently afforded investors.[39]

In addition to these general concerns, the Commission has specific comments about the nature and scope of some of the exemptions. Those comments are set forth in detail in the appendix to this testimony.

To the extent that H.R. 18 seeks to allow banks to continue engaging in traditional banking activities, it would be preferable to rely on Commission exemptive authority (as provided under Section 122 of the bill), rather than devising multiple statutory exclusions for banks. At a minimum, the Commission should be granted authority to impose additional

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[38] For example, the networking exclusion is consistent with existing Commission policies -- although incorporation of this exclusion into legislation would deprive the Commission of flexibility it would otherwise have to adapt the exclusion in response to changing circumstances.

[39] The Commission also notes that it will be difficult to monitor and enforce the proposed exemptions. Although H.R. 18 suggests that monitoring such exemptions is appropriate, the tools to do so are not in place. Specifically, the bill allows, but does not require, bank regulators to obtain information from banks regarding the banks' use of the exemptions. Notably, the bill does not require a copy of such data to be provided to the Commission. [See sec 103 of H.R. 18]

safeguards or to create specifically tailored exemptions in consultation with the appropriate banking regulators to account for the continually evolving financial markets.[40] The Commission also could use such authority to adjust the exemptions to address any untoward movement of securities activities out of broker-dealers and into banks.[41]

B. Bank investment advisory activities

H.R. 18 would amend the Investment Company Act and the Advisers Act to address a number of issues raised when banks manage and provide other services to registered investment companies. Most importantly, the bill would amend the Advisers Act to remove the exclusion for banks and bank holding companies that provide investment advice to funds. As a result of this amendment, a bank or a holding company that serves as an adviser to a fund would be regulated in the same manner as any other investment adviser to a fund. The Commission strongly supports this change.[42]

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[40] Such authority would be similar to the authority H.R. 18 proposes to confer on the Federal Reserve, with respect to modification of the statutory "firewalls" provisions.

[41] Alternatively, in the event the exemptions are retained, they should be revised (1) to prohibit the general solicitation of the securities services involved, and (2) to "expire" upon the affiliation of a bank with a securities firm. These limitations would be consistent with the assumption that underlies the exemptions, i.e., the idea that banks have traditionally provided securities services as an "accommodation to customers," and should be allowed to continue providing such traditional services so long as they are not conducting a general securities business. Notably, a prohibition against general solicitation is already contained in H.R. 18's exemption for bank trust activities, and a built-in "expiration" is included in H.R. 18's exemptions for municipal securities, affiliate transactions, private securities offerings, and de minimis transactions. A built-in expiration would prevent securities firms from transferring dealer activities that are not traditional banking services, such as dealing in structured notes, to the affiliated bank and away from Commission oversight.

[42] The bill would allow banks to segregate their fund investment advisory activities in a separately identifiable department or division ("SID"), and to register the SID (rather than the bank as a whole) as an investment adviser. The primary benefits of requiring banks and SIDs that advise investment companies to register under the Advisers Act would be the application of the following provisions: (1) the regulation of performance fees under Section 205; (2) the requirement under Section 204A to establish procedures designed to prevent the misuse of non-public information; and (3) the Section 206 anti-

(continued...)

H.R. 18 also would add provisions to the Investment Company Act that are designed to address conflicts of interest and other potential abuses that may exist when banks advise registered investment companies. Because the Investment Company Act and the Advisers Act did not contemplate that banks would be active participants in the fund industry, the statutes do not specifically address these conflicts of interest. The Commission agrees that these statutes should be updated to reflect the greater involvement of banks in the fund business. We believe, however, that the Commission would be better able to address conflicts of interest involving funds and banks if it were given authority to define and deal with those conflicts by rule or order. This authority would allow the Commission to strike a balance between protecting investors from abusive conflict of interest situations and enabling funds to engage in transactions with affiliated banks that could be beneficial to shareholders. This approach would also permit the Commission to avoid time-consuming case-by-case applications for exemptions from outright prohibitions, which could become a drain on Commission resources.[43]

Finally, H.R. 18 would address the issue of investor confusion by prohibiting funds and their affiliated banks from sharing common names.[44] The bill also would amend the Investment

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[42](...continued)
fraud provisions, which are somewhat broader than the anti-fraud standards under other applicable securities laws. Registration would also improve the Commission's ability to inspect bank-advised funds by requiring banks and SIDs to provide the Commission with additional information regarding the investment management of these funds.

[43] More detailed comments on some of the bill's specific provisions are set forth in the appendix to this testimony.

[44] This issue has long concerned the Commission. Two years ago, the Commission staff advised investment companies that the use of common names is presumptively misleading. See Letter to Registrants from Barbara J. Green, Deputy Director, SEC Division of Investment Management (May 13, 1993). This letter noted that the presumption could be rebutted through appropriate disclosure. The letter requires bank-sold and bank-advised funds to prominently disclose in their prospectuses that fund shares are not deposits or obligations of, or guaranteed or endorsed by, the bank and that (continued...)

Company Act to require disclosures by bank-affiliated investment companies that securities issued by such companies are not deposits, are not insured by the FDIC, and are not otherwise obligations of the affiliated bank. In both these instances, the Commission supports H.R. 18's goals.[45] Again, however, we believe that a somewhat more flexible approach could be taken on these matters; our detailed comments are set forth in the attached appendix.

C. The problem of regulatory duplication and overlap

As described above, the Commission believes that H.R. 18 would make important progress toward a system of functional regulation. However, the Commission believes that H.R. 18 could go still farther than it does to reduce regulatory duplication. In part, the Commission is concerned that some of the inefficiencies and overlap inherent in today's regulatory structure for bank securities activities would carry forward under the bill.

To the extent that H.R. 18 would require banks to conduct their securities activities in separate affiliates or departments, subject to Commission regulation, the bill would significantly improve the regulation of bank securities activities today. Moreover, certain provisions in the

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[44](...continued)
the shares are not federally insured by the FDIC, the Federal Reserve Board, or any other agency.

[45] These provisions would respond to the issue (identified in articles and studies) of customer confusion about the uninsured status of bank-sold mutual funds. See, e.g., SEC News Release 93-55, "Chairman Levitt Announces Results of SEC's Mutual Fund Survey" (Nov. 10, 1993); "Banks' Fund Sales at Issue," New York Times, March 9, 1994, at D2.

Recently, the NASD also took steps to address the customer confusion issue. A pending NASD rule proposal would establish requirements governing broker-dealers that sell securities on bank premises. See NASD Notice to Members 94-94 (December 1994). The proposed rule would, among other things, specify where on bank premises a broker-dealer may provide securities services; limit the activities and compensation of unregistered personnel; require broker-dealers to implement supervisory procedures; and mandate specified disclosures to customers. This rule may be revised before it is filed with the Commission for approval.

bill would facilitate coordination between bank and securities regulators in a way that would promote functional regulation. For example, Section 140 of H.R. 18 requires the appropriate agencies to provide each other with examination reports or other information related to the investment advisory activities of banks to the extent necessary for each to carry out its respective statutory responsibilities. This provision is intended to discourage duplicative examinations of banks, conserve governmental resources, and prevent inconsistent regulation of banks that engage in investment advisory activities.

Other provisions of H.R. 18, however, appear to be inconsistent with these goals, and would leave room for continuing regulatory overlap and confusion. The Commission understands that the banking agencies have a valid interest in obtaining information about affiliates' operations to the extent that such operations affect a bank's safety and soundness. But proposed BHCA § 10(f)(13)(D) suggests that the federal banking agencies have a role to play in evaluating the compliance of registered broker-dealers, investment advisers, and investment companies with the federal securities laws. This is the responsibility and function of the Commission, not of the banking agencies. Similarly, proposed BHCA § 10(f)(13)(H) suggests, by negative implication, that the federal banking regulators may conduct independent inspections or examinations of any investment company affiliated with or advised by a bank. Such investment companies, of course, are comprehensively regulated by the Commission, and should not be subject to the possibility of dual examinations.

The Commission believes that H.R. 18's enhanced information-sharing and coordination provisions should be strengthened and clarified. It would also be helpful if H.R. 18 modified existing banking law to clarify and limit the extent to which the federal banking agencies can impose bank regulation on registered securities firms affiliated with banks.

D. Two-way street

As noted above, repeal of the Glass-Steagall Act would not necessarily enable securities firms to acquire banks. In response to this problem, H.R. 18 would give securities firms two options.

First, a securities firm could become a bank holding company by acquiring an insured bank. The bank holding company could retain certain "financial" activities that would not be permitted for bank holding companies generally. The barrier between banking and commerce would be retained, however, and the securities firm would have to divest any nonfinancial business within a maximum of ten years.

A second possibility for a securities firm would be to acquire or spin off a wholesale bank and become a new "investment bank holding company" ("IBHC") that could engage in activities financial in nature and that would have access to the FedWire and discount window.[46] As a result, securities firms (which often have affiliates that engage in activities otherwise impermissible under the Bank Holding Company Act) could become IBHCs.

The Commission strongly supports efforts to promote a "two-way street;" however, we have a number of concerns regarding how these specific provisions would be implemented. As more fully described above, securities firms, already subject to Commission regulation, may be reluctant to submit to an additional overlay of Federal Reserve oversight. It is not clear, therefore, whether these options, as currently drafted, create a meaningful opportunity for many securities firms.

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[46] Such companies would be barred from controlling "retail" banks (i.e., banks that accept insured deposits); they could control only "wholesale financial institutions," defined as uninsured state banks that are regulated by the Federal Reserve.

In addition, the Commission is concerned that the IBHC proposal may inadvertently create incentives for securities firms to transfer some of their securities activities to a wholesale financial institution and away from NASD and Commission oversight. This could occur if an existing securities firm decided to take advantage of some of the numerous new exemptions for "traditional bank activities" in order to move securities activities into the wholesale bank. For example, a securities firm with a substantial government securities business could form an IBHC and transfer its government securities business to the bank in order to gain access to the Federal Reserve payments system and discount window. Shifting such activities out of a broker-dealer and into a bank would remove them from the well-developed investor protection requirements contained in the federal securities laws.

Notwithstanding these comments, the Commission believes that H.R. 18's "two-way street" provisions do present securities firms with options that they do not have today. In particular, the IBHC vehicle, with the more limited form of bank-style regulation contemplated, offers a good foundation for a continuing dialogue.

V. Conclusion

The Commission supports the goal of financial services modernization, and believes that H.R. 18 represents a good first step in that direction.

As the debate on Glass-Steagall reform goes forward, the Commission urges Congress to go beyond bank safety and soundness, and also to consider the needs of investors and the markets. In particular, the Commission urges Congress to keep these principles in mind:

- Investor protection -- as well as bank safety and soundness -- must be a priority.
- The vitality of the securities markets should not be undermined by cumbersome or inequitable regulation.

The Commission looks forward to working with the Committee on these issues.

APPENDIX: COMMENTS ON H.R. 18

This appendix supplements the general comments set forth in the Commission's testimony of March 15, 1995; it contains technical comments on specific provisions of H.R. 18.

A. Bank broker-dealer provisions

As noted in the March 15th testimony, the Commission has both general and specific concerns about H.R. 18's thirteen exemptions from the definition of "broker" and four exemptions from the definition of "dealer." Our specific concerns include:

Private placements. The exemption for bank private placement activities excepts from functional regulation a traditional, and increasingly significant, broker-dealer activity. One aspect of this exemption would permit a bank (that has no securities affiliate) to sell securities to persons with at least $200,000 in annual income as part of a private placement, without being subject to regulation as a securities broker-dealer. We question why an important and growing area of securities activities should be excluded from a functional regulation approach based on the registration status of the securities in question: there is no rationale for why private placement activity should not be subject to Commission oversight merely because it is engaged in by a bank, when all others engaging in identical activities are be subject to Commission oversight.

De minimis exemption. This exemption would permit a bank (that has no securities subsidiary or affiliate) to effect up to 1,000 securities transactions in a year -- 800 transactions in securities for which a ready market exists, plus 200 transactions in any security. Thus, a bank could advertise and actively market to any investor, without securities regulation, some of the same securities that have been subject to heightened Commission scrutiny in recent years for sales practice abuses, such as penny stocks and limited partnership interests.

Safekeeping, clearing, and related services. The Commission agrees that banks should not be considered broker-dealers solely by virtue of acting in their traditional and customary manner in providing safekeeping and custody services, clearance and settlement transactions in securities, securities lending, and collateral agency services. We emphasize, however, that any exemptions along these lines should be expressly limited to traditional and customary activities as currently performed by U.S. banks. Otherwise, the exemptions could create incentives for broker-dealers that currently engage in such businesses to move these activities into an affiliated bank and use them as an avenue to market their brokerage services away from Commission oversight. Furthermore, all activity in this area is not simply incidental to banking. Some banks, for example, currently are marketing their brokerage services to pension plans that have an existing relationship with their custody services departments by offering commission rebates on trades.

Government securities. The Commission is particularly concerned by the exemption for activities in government (including government sponsored enterprise ("GSE") securities). The category of government securities encompasses a broad spectrum of instruments, ranging from Treasury bonds to GSE structured notes, such as the ones purchased by Orange County. As demonstrated by Orange County's recent investment in structured notes, investor protection concerns arise even with the most sophisticated investors.[1]

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1 See Testimony of Arthur Levitt, Chairman, Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs (January 5, 1995).

The Commission recognizes that certain of these activities have historically been conducted in banks. Nonetheless, we believe that if a bank subsequently affiliates with a securities firm, the bank's government securities activities should be transferred to the securities firm.[2] The Commission is concerned that H.R. 18's exemption for exempted securities is too open-ended and creates an incentive to move government securities activities out of securities firms and into bank subsidiaries to gain access to the Federal Reserve Board payment system and discount window, thereby generating substantial savings in transaction costs. This would result in moving such activities away from Commission and NASD oversight, into affiliated banks. This would undercut the principle of functional regulation.

Moreover, creating an incentive for securities firms to transfer their government securities business to affiliated banks would serve to undermine the goals of the Government Securities Act Amendments of 1993 ("Amendments"). When Congress passed the Amendments, it was aware that non-banks did the bulk of government securities dealing.[3] In that context, Congress determined that it was desirable to grant the NASD authority over broker-dealers that are government securities dealers as a way of establishing sales practice requirements for government securities transactions analogous to those currently in effect for registered broker-dealers generally.[4]

Solutions. As noted in the text of today's testimony, to the extent that H.R. 18 seeks to allow banks to continue engaging in traditional banking activities, it would be preferable to rely on Commission exemptive authority (as provided under Section 122 of the bill), rather than devising multiple statutory exclusions for banks. At a minimum, the Commission should be granted authority to impose additional safeguards or to create specifically tailored exemptions in consultation with the appropriate banking regulators to account for the continually evolving financial markets.[5] The Commission also could use such authority to adjust the exemptions to

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2 Banks already have an exemption for certain government securities dealer activities. For example, banks whose only government securities dealer activities are exempt activities, including sales and subsequent repurchases pursuant to a repurchase agreement, are exempt from complying with many of the regulatory requirements of Section 15C of the Securities Exchange Act of 1934. The Commission believes that these types of activities should continue to be conducted within the bank.

3 As of January 1995, 37 of the 38 primary dealers in government securities were registered with, and regulated by, the Commission. In addition, 2,156 registered broker-dealers dealt in government securities as part of a broader business. Only 310 banks -- a significantly smaller number when compared both with the number of registered broker-dealers that are government securities dealers and the total number of banks overall -- dealt in government securities. The Office of the Comptroller of the Currency is the primary regulator for the majority of banks (198) that are bank government securities dealers.

4 As a 1990 GAO report noted, "the absence of fair dealing . . . makes transactions in government securities by some individuals and smaller institutional investors potentially vulnerable to abusive dealer practices . . ." U.S. Government Securities: More Transaction Information and Investor Protection Measures Are Needed, GAO/GGD 90-114 (September 1990).

5 Such authority would be similar to the authority H.R. 18 proposes to confer on the Federal Reserve, with respect to modification of the statutory "firewalls" provisions.

address any untoward movement of securities activities out of broker-dealers and into banks. The other route -- building a large number of inflexible exceptions into the statutory framework -- by contrast, is much more likely to result, over time, in a large number of bank securities activities being conducted outside of the broker-dealer regulatory scheme.[6]

Alternatively, many of the exemptions (which are largely derived from the concept that banks traditionally provided securities services as an "accommodation to customers") could be revised to prohibit the general solicitation of the securities services involved. Such a prohibition is already contained in the exemption for bank trust activities: H.R. 18 provides that a bank will not be considered a "broker" by virtue of its trust activities unless the bank publicly solicits brokerage business (other than by advertising such services in conjunction with other trust activities). Inclusion of a comparable prohibition is particularly important with respect to the de minimis exception, which we understand is only intended to permit smaller banks to engage in accommodation transactions for their customers.

Moreover, the Commission believes that most of the exemptions, if maintained, should "expire" upon the affiliation of a bank with a securities firm, after an appropriate transition period designed to minimize any potential disruption to a bank's business practice. Such an approach is already used in several of the exemptions (e.g., the exemptions for municipal securities, affiliate transactions, private securities offerings, and de minimis transactions). In particular, this limitation should be incorporated into the exemption for exempted securities, including government securities. Otherwise, securities firms will have an incentive to permanently transfer their government dealing activities to the affiliated bank and away from Commission oversight.

B. Margin requirements

H.R. 18 would amend the Exchange Act to eliminate outdated restrictions on broker-dealer borrowing. Specifically, the bill would remove the restrictions that prevent broker-dealers from borrowing against securities to finance their normal business operations.[7]

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6 In addition, the Commission notes that it will be difficult to monitor and enforce the proposed exemptions. Although H.R. 18 suggests that monitoring such exemptions is appropriate, the tools to do so are not in place. Specifically, the bill allows, but does not require, bank regulators to obtain information from banks regarding the banks' use of the exemptions. Notably, the bill does not require a copy of such data to be provided to the Commission.

7 As currently written, Section 123 amends Sections 7(d) and 8(a) of the Exchange Act to permit broker-dealers to borrow from any person other than a broker-dealer to finance their ordinary business operations (other than to purchase securities for their own account). Although we understand the intention of H.R. 18 is to permit broker-dealers to borrow from any person for the purpose of purchasing or carrying securities, Section 7(d) of the Exchange Act governs the ability of persons other than broker-dealers to extend credit for the purchase or carrying of securities. Section 7(c), which is not amended in the current draft, governs the ability of broker-dealers to extend credit for the purpose of purchasing or carrying securities. The bill should amend Section 7(c) to clarify that broker-dealers may extend credit to other broker-dealers for use in the ordinary course of business (other than for the purchase of securities for their own account).

H.R. 18 also would permit broker-dealers to borrow against securities from any person that agrees to observe the rules of the Federal Reserve Board. The evolving nature of our financial markets, with greater reliance on non-bank sources of financing, has made the current limitation to bank sources of financing on securities unnecessary. We therefore believe H.R. 18 would appropriately (1) loosen the restrictions on borrowing to finance broker-dealer activities (including the purchase of securities for customers), and (2) restrict borrowing against securities to purchase for a broker-dealer's own account.

C. Bank investment advisory activities

The Commission supports H.R. 18's efforts to update the Investment Company Act and the Advisers Act in light of growing bank involvement in the investment company business. However, because this involvement is a relatively new development, we believe (as a general matter) that it would be advisable for many of the investment company provisions to be modified somewhat to give the Commission authority to deal with conflicts of interest and other issues as they arise.

Customer confusion. H.R. 18 is intended to address potential customer confusion caused when investors purchase securities on bank premises or purchase shares of a mutual fund that has a name similar to that of a bank. We commend H.R. 18 for seeking to deal with this issue, which has long concerned the Commission.[8]

First, the bill would amend the Investment Company Act to prohibit a bank-affiliated investment company from adopting a name that is the same as or similar to the name of its affiliated bank.[9] The Commission believes that consideration should be given to recasting this important provision to authorize the Commission to adopt rules or issue orders to regulate this practice. In particular, the Commission recommends that the provision be revised to state that it is deceptive or misleading for an investment company to use a name similar to that of an affiliated bank in contravention of Commission rules or orders. This approach would avoid an outright prohibition of common names under all circumstances, and enable the Commission to respond to particular names it concludes are potentially confusing to investors.

Second, H.R. 18 would amend the Investment Company Act to prohibit investment companies or sellers of investment company securities from implying or representing that the company or any security issued by the company is guaranteed by the U.S. government, insured by the FDIC, or guaranteed by a bank. In addition, the bill would mandate that the Commission adopt rules to require that bank-affiliated investment companies and persons selling

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8 Because common names can be a source of customer confusion, the Commission has advised investment companies that the use of common names is presumptively misleading. See Letter to Registrants from Barbara J. Green, Deputy Director, SEC Division of Investment Management (May 13, 1993). This letter noted that the presumption could be rebutted through appropriate disclosure. The letter requires bank-sold and bank-advised funds to prominently disclose in their prospectuses that fund shares are not deposits or obligations of, or guaranteed or endorsed by, the bank and that the shares are not federally insured by the FDIC, the Federal Reserve Board, or any other agency.

9 Under the provision, the Commission would have the authority to exempt an investment company from this prohibition if it determines that an exemption is consistent with the public interest and the protection of investors.

bank-affiliated investment company securities prominently disclose that the investment company or any security issued by the company is not FDIC-insured and is not otherwise an obligation of the affiliated bank. The Commission agrees that such disclosure is necessary, but would recommend a more flexible approach. In particular, we recommend that the provision be revised to require bank-affiliated investment companies, and persons who sell securities issued by such companies, to make disclosures along the lines contemplated by H.R. 18 in accordance with such rules as the Commission may prescribe.

Conflicts of interest. Banks are now significant participants in the fund industry. Because this was not the case when the Investment Company Act and the Advisers Act were enacted, these statutes currently do not address all of the conflicts of interest that may arise when banks provide investment management and related services to funds. H.R. 18 recognizes these conflicts, and addresses them by prohibiting certain transactions between funds and their bank affiliates. We believe that the Commission would be better able to address such conflicts if it were given authority to define and deal with those conflicts by rules or orders. This would permit the Commission to strike a balance between protecting investors from abusive conflict of interest situations and enabling funds to enter into advantageous transactions. The following paragraphs discuss the specific provisions of H.R. 18 relating to these conflicts of interest.

Fund acquisition of securities to satisfy bank customer's indebtedness. H.R. 18 would prohibit an investment company from knowingly acquiring a security during the existence of an underwriting or selling syndicate, if the proceeds would be used to retire any part of an indebtedness owed to an affiliated person of the investment company. This provision is intended to address the possibility that a bank could use its affiliated fund as a source of readily available capital to assist a financially troubled borrower. The bank's indebtedness would be repaid, but the fund could be left with unsuitable or risky assets. H.R. 18 would prevent this scenario from occurring. We recommend, however, that the bill be amended to provide the Commission with authority to prohibit specific abusive situations of this type by rule or order. The Commission is concerned that, because of the broad wording of this provision, the bill could be read to preclude securities acquisitions that would not be abusive.[10] The recommended approach would allow regulatory flexibility and would avoid prohibiting investment companies from participating in appropriate and potentially advantageous securities transactions.

Borrowing from an affiliated bank. H.R. 18 would prohibit a registered investment company from borrowing money from an affiliated bank. This prohibition is intended to deal with the potential for overreaching by a bank in a loan transaction with an affiliated fund. H.R. 18 would authorize the Commission to grant exemptions from this prohibition. Under the Investment Company Act, mutual funds may borrow only from banks. As discussed above, because the Investment Company Act contemplates that banks would not have an active role in the management of funds, the statute does not specifically address potential overreaching when the lending bank is affiliated with the fund. The Commission supports addressing this issue legislatively, but we recommend that the bill be amended to provide the Commission with authority to adopt rules or issue orders that limit or prohibit banks from lending to affiliated

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[10] For example, this provision could be read to prohibit an equity fund from acquiring stock of an issuer whose publicly traded debt securities happen to be in the portfolio of an affiliated bond fund. Moreover, this provision may increase the compliance responsibilities of an investment company to monitor the securities holdings and lending activities of all of its affiliates. We question whether the interests of investors will be furthered by imposing such an extensive compliance burden on funds.

funds in those instances in which the potential for overreaching exceeds the potential benefits to fund shareholders.[11]

Bank serving as custodian for affiliated fund. H.R. 18 would permit management investment companies to use affiliated banks as custodians in accordance with Commission rules.[12] While the Investment Company Act already gives the Commission rulemaking authority regarding investment company custodial arrangements, H.R. 18 would confirm that this rulemaking authority extends to custodial arrangements involving affiliated banks.[13] We support this provision.

Independence of board of directors. H.R. 18 contains provisions that are intended to strengthen the independence of a fund's board of directors. It would expand the definition of "interested person" of an investment company to include (1) any person who, within the past six months, executed any portfolio transactions for, engaged in any principal transactions with, or loaned money to the investment company, (2) any person who, within the same period, has acted as custodian or transfer agent for the investment company, and (3) any affiliate of such persons.[14] H.R. 18 also would amend the provision of the Investment Company Act that prohibits a majority of an investment company's board of directors from consisting of persons who are officers, directors, or employees of any one bank. The bill would expand this restriction to cover officers, directors, or employees of any single bank holding company (including its subsidiaries and affiliates) or of any single bank (including its subsidiaries). We support this provision.

Voting requirements when bank holds controlling interest in fund as a fiduciary. Next, H.R. 18 would address certain conflicts that may arise when a bank that advises a fund

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11 Placing the restriction on banks would be consistent with the affiliated transaction provisions of the Investment Company Act, which prohibit affiliated persons from engaging in transactions with a fund, but do not make it unlawful for the fund itself to enter into an affiliated transaction. Because a fund's day-to-day operations typically are managed by its investment adviser, the adviser has the ability to cause the fund to enter into affiliated transactions. The affiliated transaction provisions recognize this and place the burden of compliance on the adviser and other affiliated persons rather than on the fund. These provisions, therefore, empower the Commission to pursue enforcement actions directly against those persons that cause the fund to enter into affiliated transactions.

12 The bill would prohibit unit investment trusts ("UITs") from using affiliated banks as custodians until the Commission permits such arrangements by rule. There appears to be no reason to distinguish between the custodianship of UIT assets and that of other investment company assets and, therefore, we recommend that this provision be modified to permit UITs to use affiliated bank custodians in accordance with Commission rules.

13 While the rule governing investment company self-custody of assets has been applied to cover custodial arrangements with affiliated banks, we believe the Investment Company Act should be amended to indicate more clearly the Commission's authority to adopt rules relating to affiliated bank custodianships.

14 We question the need to include custodians, transfer agents, and their affiliates as interested persons. It would appear that the conflict of interest potential raised by a board member's being affiliated with a custodian or transfer agent is rather minimal.

also holds a controlling interest in the fund in a fiduciary capacity.[15] To ensure that the bank does not use its fiduciary authority to further its own interests (such as voting to perpetuate itself or its affiliate as investment adviser to the fund), H.R. 18 would require the fiduciary to follow certain procedures when voting fund shares.[16] The voting requirements would not apply to banks holding investment company shares on behalf of common trust funds, pension plans, governmental plans, and collective trust funds. We support this provision with minor technical changes to clarify these exceptions.

Acquiring investment company shares as a fiduciary. Finally, H.R. 18 would add a new provision to the Investment Company Act to impose a disclosure requirement on a fund's investment adviser when the adviser purchases the fund's securities in a fiduciary capacity. The adviser would be required to provide disclosures as prescribed by the Commission to the person to whom periodic financial statements of the fiduciary account are sent (typically the person who created the trust). This provision authorizes the Commission to adopt rules to protect fund investors who are also trust beneficiaries, and, at the same time, authorizes the appropriate banking agency to review purchases by fiduciaries of securities issued by affiliated investment companies. Although the Commission acknowledges the potential conflict of interest that arises when a fund's adviser purchases shares of the fund in a fiduciary capacity, the Commission questions whether the Investment Company Act is the appropriate statute to deal with that conflict of interest. Such a conflict would appear to involve not the operations of an investment company, which are governed by the Investment Company Act, but the relationship between the bank as fiduciary and its clients or customers. The Commission submits that issues involving that relationship would be better addressed by amending the federal banking laws or the rules adopted under those laws than by amending the Investment Company Act.

Common trust funds. H.R. 18 would codify a long-standing Commission position that the exception from the securities laws available to bank common trust funds[17] applies only if the fund is used solely to accommodate bona fide pre-existing trust clients of a bank, and is not

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15 Section 2(a)(9) of the Investment Company Act (15 U.S.C. §80a-2(a)(9)) creates a presumption of "control" where a person owns more than 25% of a company's voting securities.

16 Specifically, H.R. 18 would require the fiduciary to (1) pass through voting rights to beneficiaries or certain other designated persons, (2) vote the shares it holds in proportion to all other shareholders, or (3) vote in accordance with Commission rules.

17 The federal securities laws exempt interests in common trust funds from the registration requirements of the Securities Act of 1933 (15 U.S.C §77c(a)(2)) and exclude common trust funds from the definition of investment company under the Investment Company Act (15 U.S.C. §80a-3(c)(3)). In addition, because interests in common trust funds are exempted securities under the Securities Exchange Act of 1934 (15 U.S.C. §78c(a)(12)(iii), persons effecting transactions in these interests need not register as broker-dealers. The definition in each of these statutes is virtually identical, limiting the exception to any common trust fund or similar fund maintained by a bank exclusively for the collective investment or reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian.

advertised or offered to the general public.[18] The bill would modify the language of the common trust fund exception in the Investment Company Act, and the companion provisions in the Securities Act and the Exchange Act, to restrict the exception's applicability to a common trust fund meeting three conditions. First, the common trust fund must be employed solely as an administrative convenience for the management of accounts created and maintained for fiduciary purposes. Second, interests in the fund may not be advertised or offered for sale to the public, except in connection with generic advertising of the bank's overall fiduciary services. Third, the common trust fund may not be charged any fees or expenses that, when added to any other fee charged to a participant account, would exceed the total compensation that would have been charged if no assets of the participating account had been invested in the common trust fund, except for "reasonable and necessary expenses related to the prudent operation of the fund," as determined by the appropriate federal banking agency. We support this provision.

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[18] E.g., In the Matter of The Commercial Bank and Marvin C. Abeene, Admin. Proc. File No. 30-8567 (Dec. 6, 1994). See also Investment Company Act Rel. No. 3648 (Mar. 11, 1963); H.R. Rep. No. 429, 88th Cong., 1st Sess. 11 (1963).

Breslaw
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TRANSMITTAL MEMORANDUM LEGAL DIVISION PROFESSIONAL LIABILITY	RESOLUTION TRUST CORPORATION 1717 H STREET, NW WASHINGTON, DC 20006

February 1, 1994

TO: Mark Gabrellian
Terry Arbit
Jim Igo
Carl Gamble

FROM: April Breslaw GAB

RE: Madison Guaranty Savings, Augusta, Arkansas

"Civil Fraud Review"
prepared by Kansas Office of Investigations

I received the attached memo through the interoffice mail today. Due to the pace at which we are working, I am circulating it without reviewing it in detail. However, the following points are apparent from my brief look.

1. At the time that this report was written (1/21/94), the investigators were relying on the same material that we are: criminal referrals, Gerrish reports, and examinations. No new research had been done.

2. The results of the most recent asset searches are summarized at the top of page 3. The report acknowledges that no borrower asset searches were done. However, some prominent D&O's also seem to be missing, e.g., Susan McDougal.

3. Confusion must remain regarding who within PLS is working on this project. The second paragraph on page 3 states that (among others) "the PLS Attorney for the institution" is "unaware of any subjects involved with fraudulent activity other than those discussed in the criminal referrals.". As far as I know, I'm the only PLS attorney who has ever been assigned to Madison. However, I wasn't interviewed by Investigations on this topic. The report also notes a 9/93 Plan of Investigation. I have never seen it.

4. On page 4, the investigators summarize portions of the 1987 Gerrish report. This is useful only insofar as it lists the 4 biggest projects. For example, as noted in my review of the Maplecreek transaction, the "possible forgery" referenced in this summary is a non-issue for civil purposes because it is apparent from other evidence that the individual whose name may have been forged did buy the property concerned.

5. At the end, the report does contain a useful list of individuals who we should investigate.

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Breslaw
16

PRIVILEGED

To: John J. Adair@IG@RTCDC
Cc:
bc:
From: April A. Breslaw@Legal-pls@RTCDC
Subject: Rose firm inquiry
Date: Monday, March 21, 1994 11:39:09 EST
Attach:
Certify: N
Forwarded by: John J. Adair@IG@RTCDC

Forwarded to: Steven A. Switzer@IG@RTCDC,Clark W. Blight@IG1@RTCDC
Patricia M. Black@IG@RTCDC
cc:
Forwarded date: Monday, March 21, 1994 13:47:50 EST
Comments by: John J. Adair@IG@RTCDC
Comments:

For your information.

Jack

-------------------------- [Original Message] -------------------------

It is my understanding that the RTC OIG is conducting a review of the Rose Law Firm. However, no one has contacted me about documents or requested an interview.

When OCOS performed its last review of the Rose Firm in January 1994, I was asked for a limited number of documents but was never interviewed. Nevertheless, the OCOS submission to the Conflicts Committee noted repeatedly that I had "stated" various things. As far as I can determine, all of these "statements" are derived from one email that I sent to Julie Yanda in our Kansas Professional Liability Office.

Oddly, however, key points in the email were ignored. For example, the email states that no one has been able to point to any evidence that Seth Ward, the individual related by marriage to Webster Hubble, actually benefitted by virtue of the Rose Firm retention. This is current information. On the other hand, a statement in a letter by a Mr. Schenk written almost 5 years ago - at a time when no one could predict how the Ward litigation would turn out - is prominently featured in the OCOS report. (This is the statement that it would be "naive" to think that Hubble would refrain from illicitly assisting Ward.)

Regarding the Schenk letter, it should be noted that that letter was written in August 1989 from Schenk to O'Donnell. It was not addressed to me. I do not know where the FDIC found the letter, but it was not found in my files. I did not learn of its existence until the FDIC released it to the news media in December 1993. The OCOS report is simply incorrect when it states that I responded to Schenk's concerns through a letter sent to another person in ... months before Schenk's letter was written.

006223

(873) factual discrepency because I was disturbed to see a report from the AP news service on March 14, 1994 which quoted an email which I sent to Mr. Womble of OCOS in January. My email to Womble explained that when the RTC recived the Frost files from the FDIC, the legal bills were missing. In

PRIVILEGED

January, this was accurate. However, the FDIC has since found most of the bills and turned them over to us. Obviously, whoever leaked my email to the news service was not aware of the current situation. These bills are all accompanied by "Fee Bill" memos which document that their payment was approved both by me an by the people who supervised me at the time. If you wish to see these bills and memos, please let me know.

With all due respect, I am concerned about the careless manner in which the first OCOS report was drafted. I am troubled about recurring leaks of OCOS material which prominently feature my name, but which carefully omit the names of OCOS personnel with access to relevant information. I am certainly willing to cooperate with the IG's investigation and am hopeful that it will be conducted in a more professional manner the the OCOS review.

006229

18732

Breslaw
17

To:	Felisa M. Neuringer@[illegible]
	Stephen J. Katsanos@[illegible]
Cc:	
Bcc:	
From:	April A. Breslaw@[illegible]
Subject:	madison, probably
Date:	Friday, March 11, 1994 [illegible] EST
Attach:	
Certify:	N
Forwarded by:	

Suneel Artan of Time Magazine called afew minutes ago. As soon as he introduced himself I said, "If you are from Time, then you know that you should call Steve Katsanos or Felisa Neuringer." I then hung up. As you can imagine, I don't want to stay on the phone long enough to say a "No comment". Also, I do want you to know that I have not been (a) subpeonaed or (b) invited to Congress. As far as I know, Leach wrote to Gonzales to ask that all of us show up, but Gonzales hasn't issued any invitations. Peter Knight told me yesterday that he had a copy of Gonzales' response to Leach. It said that Gonzales would give Leach's request "the consideration that it deserved". (from the wastebasket, I guess)

Breslaw
18

To: John E. Ryan@CEO@RTCDC
Ellen B. Kulka@Legal-sc@RTCDC
Thomas L. Hindes@Legal-pls@RTCDC
Mark Gabrellian@Legal-pls@RTCDC
Peter E. Knight@OGR@RTCDC
Cc:
Bcc:
From: April A. Breslaw@Legal-pls@RTCDC
Subject: Congressman Leach's statement
Date: Thursday, March 24, 1994 17:43:33 EST
Attach:
Certify: N
Forwarded by:

As you may know, Congressman Leach made a statement regarding the so-called "Whitewater" affair on the floor of the Congress today. At one point, he made specific reference to me. I want you to know that I categorically deny making the statement which he attributed to me. Mr. Leach said:

> On February 2, 1994, the day Roger Altman briefed the White House on Madison Guaranty, RTC Senior Attorney April Breslaw visited the Kansas City Office and said that Washington would like to say that Whitewater caused no losses to Madison.

I have never met Mr. Altman. I did not know that he was briefing the White House on February 2, 1994. On that date, I had not met either Ms. Kulka or Mr. Ryan. I did not say that anyone from Washington "would like to say" anything.

I would note that Ms. Lewis purports to be a "criminal" investigator. As such, she may not understand that in order to pursue a civil case, the plaintiff must be able to demonstrate that it sufferred a loss. (Of course, if a criminal defendant is shown to have caused monetary loss, he or she may be sentenced to make restitution if he or she is convicted. In that sense, "loss" is relevant to criminal matters.)

In any event, I met with Ms. Lewis briefly to see if she could shed some light on this element of the civil investigation. At the time, she seemed nervous and uncomfortable about the fact that her criminal referrals do not resolve the loss issue. She could not answer the main questions that I asked: What was the ending balance of the Whitewater checking account? Was it left in overdraft status, which would have meant that a loss occurred?

It's my opinion that the defensive, political slant to her statement is simply an effort to draw attention away from her embarrassment over failing to document a key element of the investigation.

If at all possible, I request that the RTC issue a statement which clarifies the fact that I am not a political appointee, that I did not act at the request of political appointees, and that I categorically deny making the statements attributable to me. Thank you for considering my request.

[redacted]
001333

Breslaw
19

To: Carol L. Middlebrook@Legal-pls@RTCDC
cc:
bcc:
From: April A. Breslav@Legal-pls@RTCDC
Subject: re: FOIAs 94-0301, 94-0302 and 94-0304
Date: Tuesday, May 10, 1994 10:37:26 EDT
Attach:
Certify: N
Forwarded by:

Here's my response.

94-0301: Doc's detailing contacts between RTC and White House or David Kendall between 1/20/93 and 4/1/94

Kendall defended Arthur Andersen & Co. against RTC claims for loss caused to University Savings (Houston). Along with many other people, he attended 2 meetings with the RTC at which our claims were discussed as part of global settlement negotiations. As you know, these negotiations lead to a settlement in July 1993.

I have notes from these meetings, but I do not beleive that they are responsive to this FOIA because both occurred BEFORE 1/20/93. (I assume that the reporter picked 1/20/93 as the starting point because that's when Clinton was inaugurated. Contacts which happened before then can't be twisted into allegations of presidential misconduct.)

Secondly, I beleive that these notes are subject to attorney/client privilege and should not be produced as a result. Last, they constitute evidence "of compromise" which would not be admissible under Rule 408 of the Fed. Rules of Evidence. On that basis, I do not beleive that they should be produced.

Attorney time: half hour; secretary time: one hour (to review global files)

94-0302: 1) contacts with the Republicans about Madisen in 1992

No documents. No search time because I know I never had any contact with the Bush White House, campaign, RNC, etc.

2) material which documents regeust for inveatigation of relationship between Whitewater and Madison in March 1992

No documents. Although I was listed as the PLS attorney for Madison, the investigators in Tulsa and DC did not include me in these discussions. I assume that they worked with the criminal co-ordinators. No search time, becuase I know I was not included in these discussions.

94-0304: contacts with DOJ on Madsion/Seth Ward

No contacts regarding Seth Ward. However, I have a slip of paper with 2 or 3 notes from a brief conversation with Donald McKay, a trial attorney employed by the DOJ. I believe that he was one of the "career" prosecutors who worked on the Madison criminal investigation before Fiske was poointed Special Counsel. The notes are undated, but I beleive that they were taken in late January or early February 1994.

In the course of the RTC Madison investigation, Mark Gabrellian asked Gloria Berry to obtain information on the Madison criminal prosecutions or Madison officials held in 1990. I'm not sure how Ms. Berry obtained Mr. McKay's name. However, she asked me to help her contact McKay to obtain the docket sheets from these matters. To the best of my recollection, he told me that everything was available from the clerk of the federal court in Little Rock. He did not send me any material.

I'll copy the notes and give them to you.

SEarch time: 5 minutes

HOUS2

25221

AB0053

Breslaw
20

To: Mark Gabrellian@Legal-pls@RTCDC
Cc:
Bcc:
From: April A. Breslaw@Legal-pls@RTCDC
Subject: senate doc's
Date: Tuesday, June 28, 1994 15:31:45 EDT
Attach:
Certify: N
Forwarded by:

I have the impression that we're in the midst of producing doc's to the SEnate banking committee in anticipation of the hearing scheduled for the end of July. If anybody is considering producing anything that has anything to do with my conversation with Jean Lewis, I'd like to talk about whether it's responsive to the committee's request. It's my understanding that the senate rejected amendments which might have brought this incident into the scope of the hearings.

At a personal level, I strongly request that everybody be careful not to inadvertently produce anything to do with the Lewis conversation. Such production could very well throw me into another situtaion in which I'm blindsided by crazy members of Congress who are playing to the press. If that happens, I'm not going to let myself get slammed. I will start telling my side of the story to the press and the chips will just have to fall where they may.

HOUSE

MG0472

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United States General Accounting Office

GAO

Testimony

Before the Committee on Banking and Financial Services
House of Representatives

For Release on Delivery
Expected at
2:00 p.m., EST
on Wednesday
March 15, 1995

FINANCIAL REGULATION

Modernization of the Financial Services Regulatory System

Statement of James L. Bothwell
Director, Financial Institutions and Markets Issues
General Government Division

GAO/T-GGD-95-121

FINANCIAL REGULATION
Modernization of the Financial Services Regulatory System

Summary of Statement by
James L. Bothwell
Director, Financial Institutions and Markets Issues
U.S. General Accounting Office

When Congress last considered expanding bank powers, the industry was not in very good financial condition At that time, Congress chose to follow a prudent course by seeking to get both the banking and the regulatory systems back in shape before moving forward on financial services modernization While the banking industry is clearly in better financial condition than five years ago, in GAO s view it may be premature to assume that fundamental concerns about risk management and regulatory supervision have been resolved.

Parts of the industry that were once separated have continued to converge, while the regulatory system has adapted to these changes incrementally and on an ad hoc basis. The result is a regulatory structure with overlaps, anomalies, and even some gaps. Recognizing that this may be an opportune time to restructure the laws and regulatory framework, GAO suggests a set of safeguards to avoid undue risk to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers.

-- Financial services holding companies should be subject to comprehensive regulation on both a functional and consolidated basis. While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure.

-- Capital standards for both insured banks and financial services holding companies should exist that adequately reflect all risks, including market and operations risk. Because capital can erode quickly in times of stress regulators should also be required to conduct periodic assessments of risk management systems for all the ma or components of the holding company, as well as for the holding company itself.

-- Clear rulemaking and supervisory authority should be established that includes specific requirements for cooperation and coordination among functional regulators.

-- Mechanisms should exist to prevent excessive concentration of economic power and to assure free entry into financial services markets, so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

Mr. Chairman and Members of the Committee,

We are pleased to be here today to discuss modernizing our financial services regulatory system. There are many good reasons for considering modernization legislation at this time, and the proposals now before this committee provide a wide range of options for restructuring the traditional relationships between banking, securities, and other related activities. We believe that enhancing financial sector efficiency is an important policy goal but, in pursuing that goal, we should not lose sight of other important goals, such as maintaining the safety and soundness of the financial system and the deposit insurance funds, preventing undue concentrations of economic power, and protecting consumers from potential conflicts of interests.

To best ensure achieving all of these goals, we believe any move to modernize regulation of the financial services industry should (1) provide consolidated and comprehensive supervision of all companies owning federally insured depository institutions--with coordinated functional regulation of individual components, (2) ensure capital levels that adequately reflect the amount of risk-taking, and (3) ensure that regulatory resources and capabilities keep pace with expanding bank powers and increased linkages between banking and other types of financial or nonfinancial activity. We believe these are fundamental principles that

should receive careful attention as Congress considers the best approach for modernizing the financial services regulatory system. Moving away from a financial services holding company approach or in the direction of allowing commercial or industrial firms to own banks raises particular questions and concerns which suggest that Congress should proceed cautiously.

BANKS' FINANCIAL CONDITION HAS IMPROVED, BUT REGULATORY REFORMS HAVE YET TO BE FULLY TESTED

When Congress last considered expanding bank powers several years ago, the banking industry was not in very good condition. Many banks had failed or were struggling to restore their capital, and the bank insurance fund was depleted. While bank securities activities were not as prevalent at that time, many of the reasons for taking up modernization issues were clearly evident. Congress chose to follow a prudent course by seeking first to get the banking industry back in shape. An important component of this strategy was enacting the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. This act included a number of provisions to bring the regulatory system in line with the realities of the fast-changing, highly competitive markets within which banks now operate. These provisions included prompt corrective action, under which regulators are to prevent losses to the bank insurance fund by closing banks before their capital is completely exhausted, as well as various

management, regulatory, and accounting reforms designed to strengthen bank controls over risk-taking and improve the flow of information to regulators and market participants.

While the banking industry is clearly in better financial condition today than five years ago, in our view it may be premature to assume that fundamental concerns about risk management and regulatory supervision have been resolved. Although a credit risk-based capital system has been in place for a number of years and bank capital has increased significantly, much harder to measure market and operations risks have become increasingly important for many banking institutions. And, while regulators are providing improved guidance for examining risk management systems, we believe it is too early to tell whether these actions are sufficient for today's challenging environment.

LEGISLATIVE AND REGULATORY FRAMEWORKS MAY BE OUTDATED

Having adopted interstate banking legislation last year, it is certainly reasonable for Congress to consider regulatory modernization proposals. At the very least, it seems reasonable to bring the regulatory system up to the point where it gives adequate recognition to the changes that have already taken place in the industry. Beyond that, we should strive for arrangements that have the flexibility to accommodate further changes without placing safety and soundness, consumers, and taxpayers at undue

risk.

Both the laws governing the financial services industry and the regulatory structure that oversees it were developed for an industry that was compartmentalized into commercial banking, investment banking, and insurance. Since that structure was set up, these activities have converged to the point where many of the products and services offered by these supposedly different institutions are more similar than different. Some examples include: (1) competition by money market and mutual funds for customer funds that has been so successful that shares in such funds--many of which permit check writing--are now about equivalent in volume to insured bank deposits; (2) the securitization of more than $1 trillion of mortgage and other loans that a few years ago would have been held in portfolio by insured depository institutions; and (3) involvement of banks in securities to the extent that "Section 20" affiliates of banks account for about 15 percent of the assets of all broker dealers registered with the SEC, and that bank proprietary mutual funds account for about 14 percent of the assets of all mutual funds.

While regulators have adapted to these changes in the industry, they have done so incrementally and on an ad hoc basis. The result is a regulatory structure with overlaps, anomalies, and even some gaps. For example, certain bank securities activity conducted in affiliates may be examined by both bank and

securities regulators in a way that imposes unnecessary burden on the institution. On the other hand, the capital standards applied to banks' trading activity focuses on credit risk when market and/or operations risks are equally, if not more, important.

SAFEGUARDS ARE NEEDED

While it may be an opportune time to restructure the laws and regulatory framework governing the financial services industry, we believe any legislation should include the following safeguards to avoid undue risk to the safety and soundness of the financial system, to the deposit insurance funds, and to consumers and taxpayers.

-- Financial services holding companies should be subject to comprehensive regulation on both a functional and consolidated basis. While firewall provisions are extremely important to prevent potential conflicts of interest and to protect insured deposits, an umbrella supervisory authority needs to exist to adequately assess how risks to insured banks may be affected by risks in the other components of the holding company structure.

-- Capital standards for both insured banks and financial services holding companies should exist that adequately

reflect all major risks, including market and operations risk. Because capital can erode quickly in times of stress, regulators should also be required to conduct periodic assessments of risk management systems for all the major components of the holding company, as well as for the holding company itself.

-- Clear rulemaking and supervisory authority should be established that includes specific requirements for cooperation and coordination among functional regulators.

-- Mechanisms should exist to prevent excessive concentration of economic power and to assure free entry into financial services markets, so that small businesses and consumers can be assured of receiving the benefits of modernization efforts.

<u>Supervision of Financial Services Holding Companies Should Be On a Comprehensive, Consolidated Basis</u>

While each component of a financial services holding company can be overseen by a specific, functional regulator, we believe it is important that some supervisory authority has responsibility for the entity as a whole. For example, while the SEC might be the regulator for the securities affiliate of a holding company and the OCC might be the regulator of one of the holding company's

banks, there is still a need for some regulator to look at the holding company in its entirety.[1]

All of the approaches proposed to the committee use capital standards and firewalls as the mechanisms to protect bank capital from being used to improperly support nonbank activities or to protect insured deposits in the event a nonbank affiliate becomes insolvent. While the capital of bank subsidiaries and firewalls are important safeguards, we are in agreement with the approach taken in H.R. 1062 that provides for consolidated supervision at the holding company level, in addition to firewalls. Most, if not all, bank holding companies are managed on a consolidated basis with the risk and returns of various components being used to offset or enhance one another, and investors may make little distinction between one component of the holding company and the other affiliated companies.

Currently, under the Bank Holding Company Act, the Federal Reserve acts as the overall regulator for bank holding companies. The Federal Reserve sets consolidated capital requirements for the company as a whole, has supervisory authority over the company, determines what types of activities can be affiliated with banks under the holding company structure, and approves such holding company activities as mergers and acquisitions.

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[1]For a more detailed discussion of functional regulation, see appendix.

The proposed financial services holding companies under H.R. 1062 resemble these current bank holding companies. And, like current bank holding companies, they are likely to be very complex organizations. Given this complexity, we question whether sufficient confidence could be placed in a regulatory framework that is strictly functional in nature and that concentrates primarily on enforcing bank capital rules and firewalls.

Firewalls Can Be Penetrated and Capital Can Be Dissipated Quickly

Firewalls are systems of controls that are meant to keep bank resources from improperly being used to support other activities, such as securities underwriting, and to protect against potential conflicts of interest. Ensuring that appropriate firewalls are established and maintained, and that regulators have the authority to take action when firewalls are breached, is an important part of supervising banks under a functional regulation approach. The Federal Reserve, for example, has the authority to require that firewalls be established when it authorizes bank holding companies to set up affiliates under Section 20. The Fed also has the authority to examine and enforce these firewalls on an ongoing basis.

Periodic examinations, however, cannot ensure that firewalls will hold up under stress or if managers are determined to breach

them. Thus, the protection that firewalls provide depends heavily on the fact that they are only one component of the overall regulation of bank holding companies by the Federal Reserve. Before allowing any Section 20 affiliate to underwrite debt and equity, for example, the Federal Reserve uses its consolidated supervisory authority to require the holding company to demonstrate it has adequate systems in place throughout the company to manage risks and to protect the integrity of the firewalls. Such a safeguard may not exist under a strictly functional regulatory approach.

Although an appropriate focus of regulation, capital measured in financial statements is an inexact measure of financial strength. Capital is adequate only in relationship to the risks that are being taken. In today's environment, the lack of information on proprietary trading positions, or accepted standards of adequacy in areas such as interest rate risk, underscores the uncertainty about the adequacy of capital as reported on financial statements. With today's rapidly changing financial markets, measured capital can disappear quickly in poorly managed firms.

Our concerns about placing too heavy an emphasis on measured capital reflect past experiences in which capital was dissipated before regulators were able to take action. For example, regulators waited until problems at the Bank of New England had developed to the point where asset values had to be substantially

written down. Thus, measured capital was a lagging indicator of the bank's true financial condition and even of its viability. The potential volatility of derivatives activities, along with weaknesses in accounting rules for certain of these activities, further erodes the value of reported capital as a measure of financial strength. Although FDICIA has given regulators the ability to adjust downward an well capitalized institution's capital rating, in the presence of management deficiencies, it is too early to tell how effectively this authority is being used.

Capital Standards and Risk Management Evaluations Are Important Safeguards Under Any Regulatory Framework

Establishing a measure of capital adequacy is a basic component of any approach to regulating the financial services industry. Although we have suggested some limitations to using capital as the sole mechanism for protecting banks from risks arising elsewhere in the holding company, establishing risk-based capital standards that reflect all major risks is an important safeguard for both functional and consolidated regulation. In addition, regulators need to assess the risk management system for each component of the company as well as the company as a whole.

The current risk-based capital standards for banks take account of credit risk. The only mechanism that accounts for market, liquidity, operations, or legal risk is the minimum capital

requirement or leverage ratio. Bank regulators have been attempting to establish capital requirements for interest rate risk, as required by FDICIA, but have yet to agree upon such standards.

Regulators need to have assurance that each financial institution within a holding company, as well as the holding company itself, is capable of measuring, understanding and managing the risks it is undertaking. Without such assessments, neither the company nor the regulator can be sure if capital is sufficient to cushion against the relevant risks.

Mechanisms For Rulemaking and Cooperation Are Important for Successful Functional Regulation

Affiliations between banking and other activities could be done in any number of ways. In particular, if nonbank financial institutions are allowed to affiliate with banks, the number of possible regulatory variations could be large. To make sure that the resulting functional regulatory system is effective and at the same time not burdensome on the industry, it is important (1) to have a clear mechanism for setting rules and (2) to establish mechanisms that enhance regulatory cooperation.

We believe that there should be clear rulemaking authority on critical matters, such as consolidated capital, firewalls, and

permissible activities. This can come about in a number of ways. Having the Federal Reserve serve this function, at least for large financial services holding companies, is one obvious alternative. Another approach would be to adopt an arrangement similar to that used in the Government Securities Act, in which specific agencies are given power to set rules in specific areas, with requirements for extensive consultation among the agencies. Still another approach would be to have a special interagency rule making board.

Although functional regulation sounds simple, our work makes clear that in practice it is not. No matter how much one might try to streamline regulation, our recent work reviewing Section 20 affiliates and bank mutual fund activities shows that there will be areas in which the interests and domains of different regulators overlap. Thus, we believe it is important for Congress to be as specific as possible in spelling out the need for regulators to work together to reduce unnecessary overlaps and to minimize regulatory burden.

Maintaining Competitive Markets and Open Entry

One of the unique features of the U.S. financial system is its many banks and securities firms, which help to assure the presence of a variety of financial services in virtually every community throughout the country. In our recent report on

interstate banking, we pointed out that smaller independent banks were successful in most states in maintaining their market share despite the consolidation that had been occurring. Between 1986 and 1992, banks with assets of less than $1 billion, measured in constant 1992 dollars, maintained a national market share of about 20 percent of assets, and their share increased in 9 of the 16 states with a relatively large amount of interstate banking. With further interstate banking, as with developments that might occur with the establishment of financial services holding companies, these smaller institutions have no guarantee, of course, of a stable or expanding market share, and their future will depend on such things as their abilities to serve their communities, the efficiency of their management, their desire to remain independent, and the acquisition strategies of larger banks.

To encourage the viability of small enterprises and to assure that communities of all size will have access to financial services, our interstate banking report emphasized the importance of making sure that local markets remain competitive, both through anti-trust enforcement and ensuring that potential new entrants remain free of unnecessary barriers. The same principle applies to financial modernization legislation as well. It is worth noting, for example, that one of the problems with the current Section 20 companies is that the revenue limitations (i.e., nontraditional activities can account for no more than 10%

of all revenues) contribute to making it difficult for a well capitalized, well managed, small bank holding company to set up a subsidiary to underwrite the debt or equity of small local companies.

Concerns Remain About Affiliations Between Banks and Industrial Firms

Removing all restrictions on the ownership of banks would provide the market with the maximum degree of flexibility in determining affiliations between banking and other activities, both financial and industrial. However, it also raises some unanswered questions. Is such an affiliation needed to provide adequate diversification opportunities to banks or other firms? What synergies would result from such an association? How would the public respond if a major company that owned a bank got into trouble? How would regulators be able to maintain adequate supervision of the company as a whole?

Our concerns in this area are heightened because many of the efforts of nonfinancial firms to expand to the financial services area have not been particularly successful, and increasingly companies have been concentrating on core businesses in order to survive and do well in competitive markets.

These questions and concerns suggest that Congress should proceed

cautiously with any move away from the financial holding company approach or in the direction of allowing commercial or industrial firms to own banks.

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Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any questions you may have.

An Explanation of Consolidated Holding Company Regulation and Functional Regulation

The closest model for a financial services holding company is the existing bank holding company structure. This appendix explains how bank holding companies are regulated, as well as the concepts of consolidated regulation of the holding company and functional regulation.

Large Bank holding companies are complex. They consist of combinations of banks, thrifts subsidiary holding companies, securities firms, and other nonbank firms (such as mortgage, finance or data processing companies In total, these large firms typically have many separate subsidiaries, with operations conducted throughout the U.S. and overseas.

The regulation of a bank holding company can be shown with a simplified illustration of such a company, as in figure 1. The company in this illustration consists of a national bank, a subsidiary bank holding companies, a thrift holding company, a securities firm registered with the SEC, and another nonbank subsidiary. The diagram also shows how each entity is regulated.

Consolidated Regulation of the Holding Company

Under current bank holding company regulation, the Federal Reserve System is responsible for regulating the company as a whole. This means that the Federal Reserve sets capital requirements on a consolidated basis for the company as a whole, has authority to supervise all parts of the company, determines what activities can be affiliated with banks, and approves holding company mergers and acquisitions Consolidated supervision typically involves concentrating on capital structure, key risk management systems, and the flow of funds within the company.

The holding company regulation provided by the Federal Reserve can be referred to as "umbrella" type regulation because it is in addition to other regulation of holding company subsidiaries or of the markets within which the entities of the holding company operate. This other regulation is provided by various federal and state regulators. The authority of the Federal Reserve is limited in that in some circumstances a bank regulator such as OCC can, for example, authorize activities for a national bank that the Federal Reserve cannot authorize at the holding company level.

Functional Regulation

The concept of functional regulation refers generally to a regulatory process in which a given financial activity is regulated by the same regulator regardless of who conducts the activity. In discussions about regulation of financial service holding companies, the concept can be used in somewhat different ways.

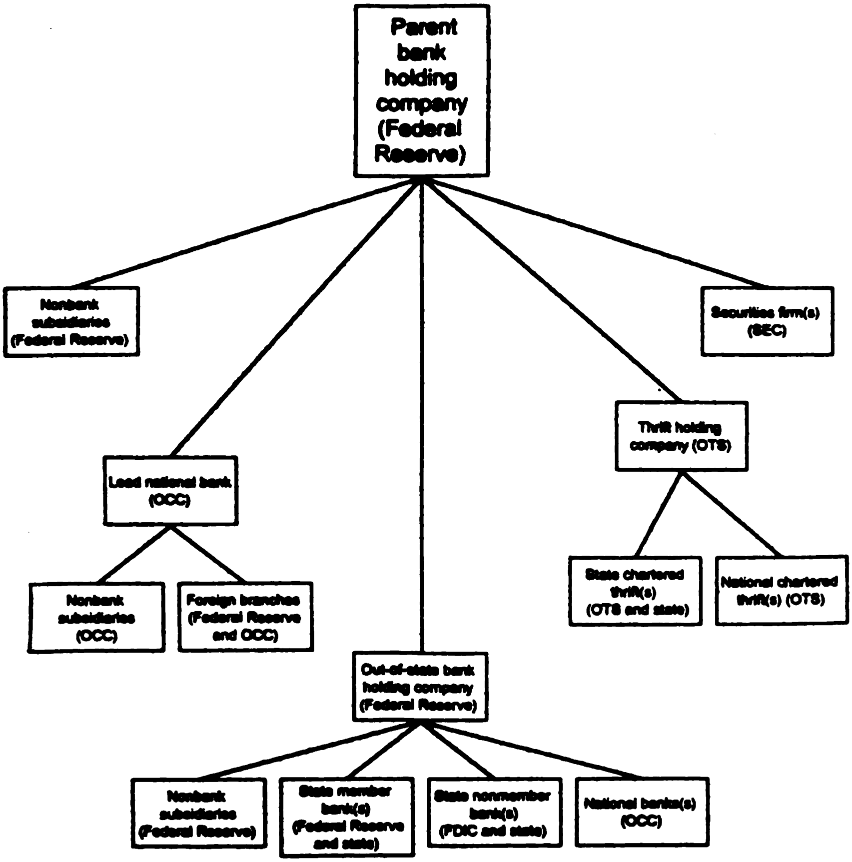
Functional regulation is sometimes used to refer principally to the idea of regulating a complex company in a way that eliminates the umbrella role, the role now played by the Federal Reserve for bank holding companies. Referring to figure 1, this approach to functional regulation means that the Federal Reserve regulation of the parent and of nonbank subsidiaries would disappear from the diagram. Regulation would then be focussed solely on the various regulated subsidiaries. For example, OCC would continue to regulate the lead national bank and the national bank in the subsidiary holding company, while the SEC (in part through the involvement of securities regulation) would regulate the securities affiliate. OCC would be responsible for setting the capital requirements for the national banks and using its supervisory authority over those banks to see that capital is not drained away by the actions of the holding company parent or of any affiliates. OCC also would enforce the firewall limitations applicable to the national banks, in which capacity it would have the ability to obtain records from other parts of the holding company.

Functional regulation can also be used to emphasize the way in which regulatory responsibilities are divided up among the various regulatory bodies. This concept is particularly important because the U.S. regulatory system combines both regulation of markets (securities exchanges, futures exchanges, and over the counter trading) and regulation of firms (banks, securities firms, thrifts, and insurance companies). With functional regulation defined in this way, the SEC, as regulator of securities markets, would set rules that apply to all firms active in those markets, whether those firms are banks, registered broker dealers, or insurance companies. The enforcement of the SEC rules can be done either by the regulator of the market or the regulator of the firm.

As the activities of various types of financial institutions have converged, the concept of regulating by function is likely to take on greater significance, extending across traditional definitions of markets as well as firms. For example, sales practice rules could be developed to apply to many products sold by many different firms in many different markets. Functional regulation viewed in this way is not inconsistent with consolidated supervision of the activities of companies which participate in many different markets.

APPENDIX

Figure 1: Regulation of a Hypothetical Bank Holding Company



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